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TAX REFORM PROPOSALS—XVII

HEARING

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

NINETY-NINTH CONGRESS

FIRST SESSION

JULY 19, 1985

EMPLOYEE BENEFITS

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TAX REFORM PROPOSALS—XVII

FRIDAY, JULY 19, 1985

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The committee met, pursuant to notice, 10 a.m. in room SD-215, Dirksen Senate Office Building, Hon. Bob Packwood (chairman) presiding.

Present: Senators Packwood, Heinz, Durenberger, Symms, Long, Matsunaga, Bradley, and Mitchell.

[The press release announcing the hearing and an opening statement of Senators Durenberger and Matsunaga follows:]

[Press Release No. 85-048]

TAX REFORM HEARINGS IN FINANCE COMMITTEE TO CONTINUE IN JULY

Examination of President Ronald Reagan's tax reform proposal will continue in July with a series of hearings before the Senate Committee on Finance, Chairman Bob Packwood (R-Oregon), said today.

"We made a good start on the hearing portion of this long process toward overhaul of the Internal Revenue Code during June," Senator Packwood said. "The hearings we have scheduled for July will take us further toward our goal of having a bill to the President by Christmas."

The hearings announced today by Senator Packwood include:

On Tuesday, July 9, the Committee will receive testimony on the President's tax reform proposal from several professional organizations. Public witnesses also will testify on July 9 on the expected impact the proposal will have on charitable contributions in this country.

On Wednesday, July 10, the Committee is to receive testimony from public witnesses on the anticipated impact the tax reform proposal will have on agriculture, timber and small business.

On Thursday, July 11, witnesses invited by the Committee will present their views on tax reform and alternative retirement arrangements.

On Tuesday, July 16, the Committee will receive public testimony on the impact of the President's proposal on housing, real estate and rehabilitation.

On Wednesday, July 17, the Committee is to hear testimony from public witnesses on the impact tax reform is expected to have on the nation's energy industry.

On Thursday, July 18, witnesses invited by the Committee will discuss the impact of the President's tax reform proposal on the international competitiveness of U.S. businesses.

On Friday, July 19, witnesses representing the public will present testimony on the projected impact the tax plan will have on employee benefit programs.

On Wednesday, July 24, representatives of America's organized labor unions will present their views to the Committee on the President's tax reform recommendations.

And, on Thursday, July 25, public witnesses are to appear before the Committee to testify on the anticipated effects of the proposal on state and local governments.

REMARKS OF SENATOR DAVE DURENBERGER, TAX REFORM HEARING, SENATE FINANCE COMMITTEE, JULY 19, 1985

Today, there will be much handwringing over the provision of the current tax reform plan that would have us tax employer-paid health benefits. Testimony from the first two panels indicate that labor, business, and insurance industry alike are against the taxing of employer-paid health benefits. The witnesses all agree that taxing the first dollars paid for employees' premiums, as proposed by the President, would be regressive tax policy and serve no worthwhile health policy purpose. I am sure they would also voice concerns over the Bradley-Gephardt flat tax proposal which would make all employer-paid premiums taxable.

Employer-paid health premiums serve an important societal function. As the distinguished chairman of this committee, my colleague Senator Packwood, has pointed out so many times, if employers do not provide health protection, then the taxpayer would have to.

Over 130 million Americans receive employer-paid health insurance, but, what they receive is not uniform. The Federal worker who is covered under the Blue Cross standard option contributes $40 a month, while his employer, Uncle Sam, pays $116 a month toward coverage for his family. His plan is a bargain, but for it, he is paying significant deductibles and copayments if he or his dependents require health care.

At the same time, workers at Chrysler receive $275 a month in health care benefits tax free. That is twice as much as the Federal employee and includes first dollar coverage, dental benefits, eye glasses—the whole nine yards. The Chrysler worker gets a "free lunch" while the Federal worker gets cost sharing. Current Federal policy says that the extravagant Chrysler plan, the open-ended benefit, is OK. But, is it?

Even worse than the inequity between good plans and extravagant ones, Americans who don't receive employer-paid health benefits and buy their own insurance receive no tax break at all.

Lee Iacocca made $5 million last year. He got $3300 in health premiums tax free from Chrysler.

The self-employed and the unemployed are on their own. They get no subsidy at all. This Nation will subsidize employer-paid health insurance to the tune of $50 billion next year according to one estimate. All Americans who are privately insured should have a fair shot at that.

Tax reform gives us an opportunity to make good tax policy and good health policy. It gives us an opportunity for reform and fairness. Those are the President's goals in his overall package.

We need to take advantage of this period of reform to revamp the tax treatment of health insurance.

I have suggested in a bill I introduced last May, The Health Equity and Fairness Act of 1985, two concepts: first, we need to end the open-ended subsidy for extravagant health plans. If we do that, we will increase cost-consciousness of health care consumers and reduce the inflationary nature of extravagant plans which generally include first dollar coverage.

I suggested in S.1211 a cap on the amount of health benefits Americans may receive tax free. A $250 cap per month for families and a $100 a month cap for individuals. It's the flip-side of the Treasury II plan, hitting the big-spender health plans rather than the modest ones. This cap is sufficiently high to affect the most expensive health plans and will affect only 5% of Americans earning less than $20,000. And, it also raises revenue equivalent to taxing at the base as the Treasury II proposal would have us do.

The second component of the bill would provide the capped deduction for health plans to all Americans whether their plans are employer-purchased or paid for by individuals. Such change is critical to give everyone an equal shot at decent health protection.

As the Committee considers tax reform, it is my intention to argue vigorously for these changes in the tax package.

It's time we recognized that the open-ended subsidies for health coverage makes no sense, particularly when we are looking down the road at $200 billion major deficits, and that what's good social policy for the employed ought to be good for those who don't receive employer-paid benefits.

I want to commend the Chairman on the comprehensive set of hearings he has been conducting on tax reform. Restructuring the tax system requires a full public hearing, and his hearings have been well-designed to give everyone an opportunity to get their views across to the Congress.

OPENING STATEMENT OF SENATOR SPARK MATSUNAGA

Mr. Chairman, I submit the statement of the Small Business Council of America and request unanimous consent that it be printed in the Hearing Record. Small Business Council of America (SBCA) is a non-profit organization which represents over 1,500 small business organizations on federal tax matters.

The statement is also endorsed by the Small Business Legislative Council (SBLC), which is a Washington-based coalition of nearly 90 trade and professional associations representing more than 4 million small businesses.

The statement is, in essence, the same one delivered before the House Ways and Means Committee by Mr. Morton Harris, President of the SBCA. Mr. Harris is from Columbus, GA. May I add, Mr. Chairman, that there is a very strong local Hawaii SBCA chapter, which serves as an invaluable resource for those of us from Hawaii who must grapple with tax issues before Congress.

The statement of the SBCA, endorsed by the SBLC, poignantly outlines the impact on small businesses which would result from the President's tax reform proposals on employee benefits. I urge its perusal by every concerned member of this Committee before making any decisions.

The CHAIRMAN. The committee will come to order, please.

Has Mr. Georgine showed up yet?

[No response]

The CHAIRMAN. If not, let's start with the first panel, and we will come back to Mr. Georgine after the first panel is done. We will take the panel of James R. Pratt from General Mills and Carl Sardegna from Union Mutual Life of Portland, ME.

Why don't you go ahead first, Mr. Pratt?

STATEMENT OF JAMES R. PRATT, VICE PRESIDENT, DIRECTOR OF TAXES, GENERAL MILLS, INC., MINNEAPOLIS, MN, ON BEHALF OF THE FINANCIAL EXECUTIVES INSTITUTE

Mr. PRATT. Thank you, Mr. Chairman.

My name is Jim Pratt. I am vice president and director of taxes at General Mills in Minneapolis, and I am today representing the Financial Executives Institute. I am the chairman of the FEI Taxation Committee.

Just a brief background. FEI is an organization of about 12,000 senior financial people in 6,000 companies, a very diverse membership. And because of that diversity we are not either supporting or opposing the President's bill as a package, but we did want to talk about some specifics with regard to employee benefits that we in FEI do have wide agreement on.

The three things that I would like to concentrate on are section 401(k), the lump-sum distribution issue and health insurance issue.

The CHAIRMAN. Let me tell you as you start, your entire statement will be in the record, but we are holding our witnesses to 5 minutes on their presentations.

Mr. PRATT. Yes. I understand that, Mr. Chairman.

First of all with respect to retirement, we do think that there is a qualitative difference between retirement provisions and the normal tax return tradeoffs that you think of. One is that, of course, there are three parties involved in retirement provisions, and the employer-employer relationship is a very very sensitive and important part of that. For that reason, if we had our way, we would like to see things with respect to retirement and health benefits taken out of tax reform and looked ay as separate issues.

The other point that I would like to make in general is that the variety and flexibility in these retirement plans can be a very important security provider for millions of people, and particularly sometimes as a supplement or a substitute for private pension plans which are generally not indexed in the private sector. These supplements can provide the kind of flexibility that people need.

With respect to specifics, I will just quickly go through the things that we are urging.

If section 401(k) has to be changed—we are not advocating it—we believe the most urgent things to change as far as the President's proposal are to retain the average method of computing the actual deferred pecentage test rather than making the computation on an individual basis. We also belive that the present rules on employer matching contributions ought to be kept.

With respect to lump-sum distributions, we just want to say that as long as we have a progressive tax system and as long as we have the potential of that progressive system becoming more progressive, we think that people need the lump-sum distribution special treatment such as the 10-year averaging. A lot of people of course have counted on it in their retirement planning and won't be protected by the relief provisions. We don't think it should be changed, but if it is, it should be grandfathered for buildups to the date of enactment.

With respect to health insurance, first of all I will say that the partial taxation of health insurance started out as a respectable idea with the so-called cap idea, which was intended not as a revenue raiser but to put pressure on health care costs. And that is a very important objective. Unfortunately, this got twisted around in the Treasury proposals to where this was no longer a cap but a revenue raiser. It doesn't seem to have any particular logic to it except as a revenue raiser. And we strongly recommend that this be taken out of any tax reform bill. It should be rejected as regressive and as setting a bad precedent for further erosion of employee benefits.

With that, I would like to thank you for the time and the opportunity to make a statement. I would be happy to answer any questions.

[Mr. Pratt's written testimony follows:]

STATEMENT ON THE PRESIDENT'S TAX REFORM PROPOSALS BEFORE THE SENATE FINANCE COMMITTEE FOR THE FINANCIAL EXECUTIVES INSTITUTE BY JAMES PRATT

My name is James Pratt and I am Vice-President and Director of Taxes for General Mills, Inc. I am testifying on behalf of the Financial Executives Institute, of which I am Chairman of the Tax Committee. We welcome this opportunity to express the views of our membership on certain aspects of the President's Tax Proposal.

The Financial Executives Institute (FEI) is a professional organization of over 12,500 individual members who are senior financial and administrative officers in over 6,000 companies in virtually all segments of the economy.

FEI's primary concern is with continued real economic growth on a national level. A serious deterrent to economic growth is the mounting size of the federal budget deficit. I quote from our letter of May 17, 1985 to each member of the U.S. House of Representatives.

> "FEI endorses Senate Concurrent Resolution 32 . . . . as a balanced approach toward achieving deficit reduction. Because of our background we can appreciate the seriousness of the country's financial condition, and, believe that positive, decisive action should be taken now to reduce the federal deficit. We consider Senate Concurrent Resolution 32 to be a significant first step . . . Admittedly it will take more than that single action to achieve the goal. However, we believe that responsible fiscal management demands that

> substantive action be taken to assure the future viability of the American economy."

In addition to FEI's concerns regarding budgetary decisions which Congress is now debating, our membership is following closely the issue of tax reform and simplification. Although FEI has taken no formal position on the overall package of changes in the President's Proposals, there is substantial agreement among our members that certain of the employee benefit and retirement provisions of that package should not be enacted as currently proposed. This testimony will specifically address these provisions and suggest what we believe to be appropriate modifications.

Revise Cash or Deferred Arrangement (Code Section 401(k)) and Employer Matching Contribution Rules (Chapter 14.06)

A cash or deferred arrangement (CODA) is qualified if it satisfies various statutory requirements, including a limit on employee elective contributions (whether made at the end of the year or through salary reduction during the year). This is accomplished by use of an "actual deferral percentage test" ("ADP Test").

The current ADP test is satisfied for a year if either of the following tests is met: (1) the ADP for the "highly compensated employees" is not more than 150 percent of the ADP for all other eligible employees, or (2) the ADP for the "highly compensated employees" is not more than 250 percent of the ADP for all other eligible employees and is not more than 3 percentage points greater than the ADP for all other eligible employees. For purposes of the ADP test, "highly compensated employees" are those employees who are more highly compensated than two-thirds of all employees eligible to make elective contributions under the CODA. The ADP for a group of employees for a year is the average of the separate deferral ratios for each eligible employee in the group. An employee's deferral ratio for a year is the ratio of the employee's elective contributions for the year to the employee's compensation for such year.

Currently, employer matching contributions are neither restricted nor required to be counted under the ADP test, although they may be counted if they satisfy the special distribution requirements of Section 401(k) and are at all times fully vested. Where employee contributions are required prior to receipt of employer matching contributions, such employee contributions must not be excessively burdensome for lower paid workers. Employee contributions of 6% of compensation or less historically have been treated as not being excessively burdensome, although the Internal Revenue Service no longer regards 6% as a "safe harbor".

The President's Proposals would alter the ADP test in a number of ways:

*The "highly compensated" employee group would be redefined. This group would generally be composed of the top 10 percent of employees by compensation and all employees earning $50,000 or more in wages. For the first time, a "highly compensated" employee would include (1) any employee (including a former employee or retiree) who during the three previous years was highly compensated and (2) a family member of an employee who is in the highly compensated group that is employed by the same employer.

*The allowable spread in the average ADP between the highly compensated and other employees would be narrowed and the limitation on contributions for the highly compensated group would be tested on an individual basis, rather than being tested on an average basis. The ADP test in many plans might only be satisfied if no member of the highly compensated group had an ADP greater than one percentage point above the average ADP for other employees.

*Under no circumstances could elective contributions for any employee exceed $8,000 per year, less any contributions to an IRA for such year. (There appears to be confusion, however, with respect to whether IRA contributions are offset against CODA contributions or vice versa.)

*Employer matching contributions would be added to employee elective contributions for purposes of the ADP test, effectively limiting the amount of employer matching contributions for the highly compensated. In this connection, it should be noted that all plans with employer matching contributions would be subject to an ADP test, whether or not they were CODA plans. If employer matching contributions were made on a fully-vested basis and subject to the CODA distribution rules, the overall allowable spread between the groups would be increased, but only by approximately one percentage point.

The purpose of the changes affecting elective contributions is to restrict the disparity in such contributions between highly compensated and other employees. The purpose of the changes affecting employer matching contributions is to curtail "excessive" employer matching contributions for highly compensated employees and to encourage employer matching contributions to be made on a nonforfeitable and nonwithdrawable basis.

We believe that these Proposals are unnecessarily restrictive and evidence a clear bias against CODAs, especially those with matching employer contributions. Frankly, we are surprised since recent studies (including an extensive survey completed by FEI) have demonstrated conclusively that CODAs are one of the most effective vehicles for retirement savings for lower and middle-income workers.

The impact that application of the proposed CODA rules would have on existing plans varies, depending upon the characteristics of the plan and the composition of the sponsoring employer's workforce. However, in some plans, employees earning as little as $20,000 annually would be considered "highly compensated" and have their elective contributions and employer matching contributions severely limited. The proposed rules also are not flexible enough to take into account differing abilities and inclinations of employees to save at various stages of their careers. For example, young workers with family obligations may be unable to save for retirement at a time when they are legally allowed to save up to 15% of their pay (based on the new deduction limitations contained in the Proposals). Later, when they are financially able to save and fast approaching retirement, they may find themselves deemed "highly compensated" and their ability to save legally restricted.

We are not concerned primarily with the fact that many highly paid corporate executives will be limited in their CODA participation. Those individuals typically have the resources and ability to utilize other savings or tax deferral mechanisms. Our primary concern is that by limiting the contributions of the "highly compensated" group, the President's Proposals will, in fact, be severely limiting the allowable contributions of rank-and-file plan participants. This results from the shift of middle income employees into the "highly compensated" group and from the restrictive ADP tests in the Proposals.

To highlight the potential impact the proposed changes would have on existing plans the following illustration is provided.

XYZ Corp. sponsors a CODA in which plan participants are allowed to contribute up to 10% of their pay to the plan on a salary reduction basis. The average savings of the non-highly compensated group is 2-1/2% of pay. Under current law, the average savings of the highly compensated group could be no more than 5-1/2% of pay (the greater of (a) 150% of 2-1/2% or

(b) 250% of 2-1/2% but no more than 3 percentage points above 2-1/2%).

If the President's Proposals are applied to the above facts and there are no employer matching contributions, each employee in the highly paid group would be restricted to saving on a salary reduction basis no more than 4-1/2% of pay (the greater of (a) 125% of 2-1/2% or (b) 200% of 2-1/2% but no more than 2 percentage points above 2-1/2%). It is assumed that the average savings of the "lower paid" group remains at 2-1/2%. Such percentage may decrease, however, in view of the fact that the Proposals may shift a number of employees who currently are the most active CODA savers in the lower paid group into the highly paid group.

Matching employer contributions could further restrict the amount allowed to be saved under the Plan, depending on whether such matching contributions are subject to the restrictive distribution and vesting requirements applicable to CODA contributions. If the matching contributions are subject to such requirements, then the sum of both the employee's salary reduction contributions and the matching contributions would be limited to 5-3/4% of pay, determined under the ADP test previously described. If, however, the matching contributions are not subject to such requirements -- for example, the matching contributions are not immediately 100% vested -- then the sum of the employee's salary reduction contributions and the matching employer contributions would be limited to 4-3/4% of pay (the greater of (a) 110% of 3-3/4% [2-1/2% plus the 50% match] or (b) 150% of 3-3/4% but no more than one percentage point above 3-3/4%).

Thus, assume that XYZ's plan provides for employer matching contributions equal to 50% of the first 6% of a participant's salary that is deferred by the participant under the plan and that such matching contributions are not immediately 100% vested.

As the attached table illustrates, the CODA provisions of the President's Proposals greatly restrict the saving capabilities of workers through a CODA. The immediate impact of these restrictions will be a significant reduction in the incentives to save through a CODA and, therefore, a reduction in the current attractiveness of these plans. This, of course, will result in reductions in plan participation. The long-run impact of these restrictions may well be the termination of many existing plans and certainly a dramatic decrease in the number of new plan formations. Given the social and economic benefits achieved through an increasing national savings rate, changes that diminish the viability of CODA's seem incongruous.

In the interest of fairness and flexibility we suggest the proposed rules be adjusted as follows:

*Permit the ADP test to be applied on an average basis for both groups as under current law (i.e., average ADP for highly compensated to average ADP of other employees).

*Retain the present law with respect to employer matching contributions. Employer matching contributions should not be limited, provided that mandatory employee contribution requirements are reasonable and matched on the same basis for all employees. In short, employer matching contributions should not be regulated by the ADP test.

*Establish a minimum elective contribution amount (i.e., a floor) which would permit all employees to contribute up to the designated minimum amount, irrespective of the outcome of the ADP test. We recommend for this purpose a minimum amount of $2,000 per year, the same as the IRA limit. Decouple the proposed ceiling on allowable elective contributions from IRA contributions. Index the minimum and maximum savings amounts for inflation.

*For administrative ease, allow large employers (i.e., those with 10,000 employees or more) to determine the highly compensated group by ignoring family members working for the same employer and those considered highly compensated in previous years.

These adjustments to the proposed rules would permit middle-income workers to save adequately for their retirement and provide the necessary flexibility for all workers to save differing amounts at various stages in their careers as their circumstances permit.

Repeal of 10 Year Special Averaging and Long-Term Capital Gain Provisions (Chapter 14.02)

Lump-sum distributions from qualified profit-sharing, stock bonus, pension and annuity plans are currently entitled to favorable tax treatment. Ten year special averaging is a method which taxes lump-sum distributions in the year of distribution as though received ratably over ten years and without regard to the recipient's other income. In addition, if an employee actively participated in the plan prior to January 1, 1974, a pro-rata portion of the distribution is eligible for long-term capital gain treatment in lieu of 10 year special averaging.

The Proposals would repeal the favorable treatment accorded lump-sum distributions and subject all distributions from qualified plans to ordinary income tax at the recipient's marginal effective rate. The reason for this change is to foster the concept of uniform tax treatment among qualified retirement plans. The proposal is unfair, however, because it would fall most heavily on those least able to afford it, namely, long service middle-income employees who have struggled to save and plan for their retirement years. Taxes for those retirees could increase by over 100%. The following table demonstrates the impact on several randomly selected recent retirees.

The settlements indicated represent the taxable portion of actual lump-sum distributions from a savings plan. (The actual distributions included amounts not subject to tax; accordingly such distributions were greater than the stated amount.) The stated tax was calculated using the applicable 1985 rates and the corresponding rates set forth in the President's Proposals.

Employee and Years of Plan Participation	Taxable Portion of Distribution	Tax		Tax Increase	
		Current Law	Proposal	Amount	%
A (30 Years)	$ 63,523	$ 8,350	$16,203	$ 7,853	94
B (28 Years)	$ 41,540	$ 4,460	$ 8,780	$ 4,320	97
C (29 Years)	$ 50,970	$ 6,090	$10,493	$ 4,403	72
D (36 Years)	$159,908	$27,200	$57,181	$29,981	110

The gradual phase-out of the current tax treatment as provided in the President's Proposals is of no help to employees who retire after 1990. Many of these employees have saved for their retirement in reliance on the favorable tax treatment that has been available for many years.

We believe the 10 year special averaging and long-term capital gain provisions of existing law should be retained for lump-sum distributions on account of an employee's death, disability, termination of employment, including prior to retirement, or attainment of age 59-1/2. As an alternative, we recommend that the current 10 year special averaging and long-term capital gain rules be grandfathered for benefits earned through December 31, 1985. Under this recommendation, an employee's accumulated distribution would be allocated on the basis of three periods of plan participation: (1) prior to 1/1/74 (eligible for long-term capital gain or 10 year special averaging), (2) subsequent to 12/31/73 but prior to 1/1/86 (eligible for 10 year special averaging), and (3) subsequent to 12/31/85 (to be taxed as ordinary income).

Include in Income a Limited Amount of Employer-Provided Health Insurance (Chapter 3.01)

Under the present Federal tax system, amounts attributable to employer contributions for health plan coverage traditionally have been excluded from employees' income. This long-standing national policy encourages employers to underwrite the cost of essential health care services for their employees. This incentive has worked well and today many millions of workers and their dependents are covered by employer-provided health coverage. The average employee and his or her family now depend on this coverage, especially in these times of escalating health care costs.

The Proposals would include as income health plan contributions made by an employer of up to $10 per month ($120 per year) for individual coverage and $25 per month ($300 per year) for family coverage. The principal reason for this proposal is to broaden the taxable income base and thus permit a reduction in marginal tax rates. Simply stated, the Proposal is designed to raise revenue.

We believe it is both unfair and unwise to tax any portion of currently non-taxable employee benefits solely to raise revenue. Many employees sacrificed their right to receive other remuneration in exchange for non-taxable health coverage. To change the rules now, simply to raise revenue, constitutes a breach of faith with American workers.

The tax is regressive in its impact. Moreover, not only would the employer contribution to the health insurance plan be subject to an income tax of at least 15% for workers, but it also would be considered wages for FICA purposes. This would raise the total tax bite to at least 22%.

Wherever there is a future need to raise revenue, the temptation may well become irresistible to include as income an additional portion of the employer contribution for health care coverage. In addition, the proposal to tax health coverage would establish a bad precedent for the unjust taxation of other employee benefits.

Conclusion

A systematic reduction in the level of currently projected deficits must be the primary objective of the Congress. While tax simplification and increased equity are certainly desirable goals, those goals must not be obtained at the expense of deficit reduction.

If there is tax reform, we believe that the modifications to the provisions contained in the President's Proposals that we discussed above are essential if indeed equity is one of the primary goals. As currently structured, these provisions of the President's Proposals would greatly undermine current employee benefit and retirement arrangements. The adverse impact of the President's Proposals in these areas would extend to workers in all age groups and at all salary levels. The modifications we have suggested would significantly reduce this adverse impact. To the extent our suggestions compromise the "revenue-neutrality" of the overall Proposal, we are ready to work with the Congress to alleviate this problem. We appreciate the opportunity to present our views.

Salary of Highly Compensated Employee	Current Law			Proposals
	*CODA (5-1/2%)	Match (2-3/4%)	Total	Total (CODA plus match cannot exceed 4-3/4%)
$ 25,000	$1,375	$ 687.50	$2,062.50	$1,187.50
35,000	1,925	962.50	2,887.50	1,662.50
50,000	2,750	1,375.00	4,125.00	2,375.00
60,000	3,300	1,650.00	4,950.00	2,850.00
75,000	4,125	2,062.50	6,187.50	3,562.50
100,000	5,500	2,750.00	8,250.00	4,750.00

*Assumes all highly compensated employees contribute at maximum permissible level.

The CHAIRMAN. I belive Senator Mitchell wants to introduce Mr. Sardegna.

Senator MITCHELL. Right. Thank you, Mr. Chairman.

I am pleased to introduce to the committee Carl Sardegna, who is executive vice president of the Union Mutual Life Insurance which is located in Portland, ME; it is one of the State's largest employers and an outstanding company. Mr. Sardegna, who I know personally, will, I'm sure, be very informative. I look forward to hearing his testimony.

Thank you, Mr. Chairman.

The CHAIRMAN. Good to have you with us.

STATEMENT BY CARL J. SARDEGNA, EXECUTIVE VICE PRESIDENT, INSURANCE OPERATION, UNION MUTUAL LIFE INSURANCE CO., PORTLAND, ME

Mr. SARDEGNA. Thank you very much, Senators.

As Senator Mitchell said, we are one of the largest life insurance companies in the United States, with over $5 billion worth of assets. We are also a recognized leader in employee benefits, particularly as it applies to small and medium-sized employers. We are the industry's leader in the group disability area, and we were the first and are the largest provider of cafeteria benefits to small- and medium-sized employers. I welcome the opportunity to appear before this committee to discuss the President's tax proposal affecting employee benefits.

I have chosen to concentrate my comments on sections 125 and 401(k) in order to dispel what appears to be a misconception.

As I am sure you will recall, Treasury's plan proposed repealing both 125 and 401(k). The President's proposal recommended retaining both sections and adding new and expanded nondiscrimination rules. We applaud the retention of these valuable employee benefits.

Union Mutual does not support the use of employee benefits in order to secure improper windfalls to certain classes of employees. We do support the public philosophy of exchanging tax-free benefits from nondiscriminatory coverage and we support nondiscrimination rules.

Unfortunately, the implementation of the philosophy in this instance is such that the proposed nondiscrimination rules do not work. When the President's proposal did not repeal section 125 outright, many believed it was business as usual for flexible benefit plans. Unfortunately, this is not true, as the new, uniform nondiscrimination rules render section 125 plans totally unworkable and result in unfair and inequitable treatment.

Under the current law, the value of benefits to a prohibited group is limited to a percentage of the value of benefits in the total plan. Under the proposed legislation, each level and type of coverage would be treated as a separate plan. That would make it difficult for a standard benefit plan to qualify; if it makes it virtually impossible for a plan with any degree of flexibility to fully qualify.

The probability of disqualification increases as the size of the employer group decreases. The net effect of the nondiscrimination rules would be to undermine the entire concept of choice, which was Congress' original intent in proposing section 125 and is important in the drive for cost containment.

We think a better and more workable approach would be measures to ensure that all employees have a reasonable financial opportunity to purchase the richest level of benefits but allowing freedom in the actual selection; 401(k) plans have similar problems. The stated purpose for a number of the President's proposals regarding retirement plans is to move these plans toward serving strictly retirement functions and to create uniformity, such that the tax incentives do not encourage the use of one type of investment vehicle over another. We concur and endorse these aims.

The President's proposal, however, fails to create the purported level playing field by denying distributions to 401(k) plans but allowing distributions for IRA's. We belive limited distributions for very narrow purposes are essential to encourage participation by lower and middle income employees and should be available to all plans. We believe distributions, with penalties, can be provided without undermining the retirement aspects of the plan.

More importantly, the President's proposals include new, and in our opinion, excessive nondiscrimination tests for 401(k) plans.

Once again, we are not opposed to nondiscrimination rules in exchange for tax-free benefits; however, recent studies demonstrate strong participation from lower paid employees in 401(k) plans, which is the best evidence that the present rules are working. Given the other proposed changes for 401(k) plans, more stringent nondiscrimination rules seem overly agressive, especially when the present ones are working.

In summary, we support the retention of sections 125 and 401(k) plans. We believe they serve important social needs. We support the philosophy of broad, nondiscriminatory coverage in exchange for tax-free benefits. In this particular instance, however, the purported technical implication does not work. We believe the philosophical goal can be reached and made to be workable, and we would be happy to work with you and your staffs to help you in designing such proposals.

Thank you, and I would be glad to answer any questions.

The CHAIRMAN. Thank you.

[Mr. Sardegna's written testimony follows:]

Unionmutual

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STATEMENT OF CARL J. SARDEGNA

EXECUTIVE VICE PRESIDENT

UNION MUTUAL LIFE INSURANCE COMPANY

BEFORE THE UNITED STATES SENATE COMMITTEE ON FINANCE

MR. CHAIRMAN, MY NAME IS CARL SARDEGNA. I AM THE EXECUTIVE VICE PRESIDENT OF UNION MUTUAL LIFE INSURANCE COMPANY WHICH HAS ITS HOME OFFICE IN PORTLAND, MAINE. WITH OVER $4.7 BILLION OF ASSETS, UNIONMUTUAL IS ONE OF THE LARGEST LIFE INSURANCE COMPANIES IN THE COUNTRY. WE ARE THE INDUSTRY'S LEADER IN GROUP DISABILITY INSURANCE, AND WE WERE THE FIRST INSURANCE COMPANY TO OFFER CAFETERIA BENEFIT PLANS TO SMALL AND MEDIUM SIZED EMPLOYERS. OUR PORTFOLIO INCLUDES LIFE, MEDICAL AND DENTAL COVERAGES, ALONG WITH A WIDE ARRAY OF GROUP PENSION PRODUCTS.

I WELCOME THE OPPORTUNITY TO APPEAR BEFORE THIS COMMITTEE TO DISCUSS THE PRESIDENT'S TAX PROPOSALS AFFECTING EMPLOYEE BENEFITS. ALTHOUGH I SHARE WITH OTHERS WHO ARE APPEARING BEFORE YOU TODAY CONCERNS ABOUT

PROPOSED CHANGES IN THE TREATMENT OF OTHER FORMS OF EMPLOYEE BENEFITS, I WILL CONCENTRATE MY REMARKS ON THE PUBLIC POLICY PRINCIPLES OF NON-DISCRIMINATION RULES AND THE RESULTING EFFECTS ON CAFETERIA BENEFITS AND CASH OR DEFERRED ARRANGEMENTS BETTER KNOWN AS SECTION 125 AND 401(K) PLANS.

I HAVE CHOSEN TO FOCUS MY COMMENTS ON SECTIONS 125 AND 401(K) IN ORDER TO HELP DISPEL WHAT APPEARS TO BE A MISPERCEPTION. AS I AM SURE YOU WILL RECALL, TREASURY'S TAX PLAN PROPOSED REPEALING BOTH SECTIONS 125 AND 401(K). SUBSEQUENTLY, THE PRESIDENT'S PROPOSAL RECOMMENDED RETAINING BOTH SECTIONS ALONG WITH NEW AND EXPANDED NON-DISCRIMINATION RULES.

WE APPLAUD THE RETENTION OF THESE VERY VALUABLE EMPLOYEE BENEFITS. ALSO, IT SHOULD BE POINTED OUT EMPHATICALLY THAT UNIONMUTUAL DOES NOT SUPPORT THE USE OF EMPLOYEE BENEFITS IN ORDER TO SECURE IMPROPER WINDFALLS TO CERTAIN CLASSES OF EMPLOYEES. WE SUPPORT THE PUBLIC POLICY PHILOSOPHY OF EXCHANGING TAX FREE BENEFITS FOR NON-DISCRIMINATORY COVERAGE, AND, WE SUPPORT NON-DISCRIMINATION RULES. UNFORTUNATELY, THE IMPLEMENTATION OF THE PHILOSOPHY IN THIS INSTANCE IS SUCH THAT THE PROPOSED NON-DISCRIMINATION RULES DO NOT WORK.

CAFETERIA PLANS (SECTION 125 PLANS)

CONGRESS HAS ACTED IN RECENT YEARS TO RECOGNIZE THE CHANGING DEMOGRAPHICS OF AMERICA'S WORK FORCE THROUGH SECTION 125 CAFETERIA BENEFIT PLANS. THESE FLEXIBLE BENEFIT PROGRAMS ARE A DIRECT RESPONSE TO THE CHANGING

DEMOGRAPHICS AND NEEDS OF EMPLOYERS AND EMPLOYEES, NOT TO MENTION THAT THERE IS EVIDENCE SUCH PLANS PROVIDE GREATER HEALTH CARE COST CONTAINMENT BENEFITS. AT THE SAME TIME, THERE HAS BEEN MOVEMENT AWAY FROM STRUCTURES WHICH ENCOURAGE PATERNALISM TOWARDS MORE PERSONAL RESPONSIBILITY ON BEHALF OF EMPLOYEES, CITIZENS, AND STATE GOVERNMENTS.

WHEN THE PRESIDENT'S PROPOSAL DID NOT REPEAL SECTION 125 OUTRIGHT, MANY BELIEVED IT TO BE "BUSINESS AS USUAL" FOR FLEXIBLE BENEFIT PLANS. UNFORTUNATELY, SUCH IS NOT TRUE AS THE NEW PROPOSED UNIFORM NON-DISCRIMINATION RULES RENDER SECTION 125 PLANS TOTALLY UNWORKABLE.

LET ME EMPHASIZE ONCE AGAIN THE UNDERLYING GOAL OF NON-DISCRIMINATION RULES, ASSURING BENEFITS ARE NON-TAXABLE ONLY WHEN PROVIDED TO A BROAD CROSS-SECTION

OF EMPLOYEES, IS A GOAL WHICH WE ENTHUSIASTICALLY SUPPORT. FORCING UNIFORMITY IN THE LEVEL OF COVERAGE, HOWEVER, IS CONSISTENT WITH PATERNALISM AND TOTALLY GOES AGAINST THE CONCEPT OF INDIVIDUAL RESPONSIBILITY AND FREEDOM OF CHOICE. ONLY WHEN INDIVIDUALS ARE FREE TO MAKE FINANCIAL CHOICES WILL THEY BECOME INVOLVED AS CONSUMERS IN THE USE OF THEIR BENEFITS, AND MOST IMPORTANTLY THEIR MEDICAL BENEFITS. RIGHT NOW THE PROPOSED NON-DISCRIMINATION RULES FOR A CAFETERIA BENEFIT PLAN WITH ONLY TWO CHOICES AND INDIVIDUAL/FAMILY COVERAGE (A PLAN WE WOULD CONSIDER TO BE A BARE MINIMUM OF CHOICES) WOULD PROBABLY BE DISQUALIFIED BY THE PROPOSED NON-DISCRIMINATION TESTS. THE PROBABILITY OF DISQUALIFICATION INCREASES AS THE SIZE OF THE EMPLOYER DECREASES. WE THINK A BETTER AND MORE WORKABLE APPROACH WOULD BE MEASURES TO ENSURE UNIFORM

AVAILABILITY OF BENEFITS AND TO ENSURE THAT ALL EMPLOYEES HAVE A REASONABLE FINANCIAL ABILITY TO PURCHASE THE RICHEST LEVEL OF BENEFITS BUT ALLOWING FREEDOM IN THE ACTUAL SELECTION.

CASH OR DEFERRED ARRANGEMENTS (SECTION 401(K) PLANS)

THE STATED PURPOSE FOR A NUMBER OF THE PRESIDENT'S PROPOSALS REGARDING RETIREMENT PLANS IS TO MOVE THESE PLANS TOWARDS SERVING STRICTLY RETIREMENT FUNCTIONS, AND TO CREATE UNIFORMITY SUCH THAT TAX INCENTIVES DO NOT ENCOURAGE THE USE OF ONE TYPE OF RETIREMENT VEHICLE OVER ANOTHER. THE PRESIDENT'S PROPOSAL FAILS TO CREATE THE PURPORTED "LEVEL PLAYING FIELD" BY DENYING DISTRIBUTIONS FOR 401(K) AND 403(B) PLANS, BUT ALLOWING DISTRIBUTION FOR IRA'S. WE BELIEVE DISTRIBUTIONS ARE ESSENTIAL TO ENCOURAGING PARTICIPATION BY LOWER AND MIDDLE INCOME EMPLOYEES AND SHOULD BE AVAILABLE TO ALL PLANS.

MORE IMPORTANTLY, THE PRESIDENT'S PROPOSAL INCLUDES NEW, AND IN OUR OPINION EXCESSIVE, NON-DISCRIMINATION TESTS FOR 401(K) PLANS. ONCE AGAIN, WE ARE NOT OPPOSED TO NON-DISCRIMINATION RULES IN EXCHANGE FOR TAX FREE BENEFITS, HOWEVER, RECENT STUDIES DEMONSTRATE STRONG PARTICIPATION FROM LOWER PAID EMPLOYEES IN 401(K) PLANS WHICH IS THE BEST EVIDENCE THAT THE PRESENT RULES ARE WORKING. GIVEN ALL THE OTHER PROPOSED CHANGES FOR 401(K) PLANS, MORE STRINGENT NON-DISCRIMINATION RULES SEEM OVERLY AGGRESSIVE, ESPECIALLY WHEN THE PRESENT ONES ARE WORKING.

SUMMARY

WE SUPPORT THE RETENTION OF SECTIONS 125 AND 401(K) AS WE BELIEVE THEY SERVE IMPORTANT SOCIAL NEEDS. ALSO, WE SUPPORT THE PHILOSOPHY OF BROAD NON-DISCRIMINATORY

COVERAGE IN EXCHANGE FOR TAX FREE BENEFITS. IN THIS PARTICULAR INSTANCE, HOWEVER, THE PROPOSED TECHNICAL IMPLEMENTATION DOES NOT WORK. WE BELIEVE THE PHILOSOPHICAL GOAL CAN BE MADE TO WORK THROUGH THE USE OF DIFFERENT TESTS AND WE WOULD BE HAPPY TO WORK WITH YOU AND YOUR STAFF TO ACCOMPLISH THIS. THANK YOU.

The CHAIRMAN. We follow a first-come first-served rule on questions, and Senator Long was the first one here today.

Senator LONG. No questions at this moment, Mr. Chairman.

The CHAIRMAN. Thank you.

Mr. Sardegna, you say that if a cafeteria plan gives two choices, individual coverage/family coverage, that it runs the risk of violating the proposed nondiscrimination rules. Elaborate on that. I don't want it to do that, but I don't quite understand why.

Mr. SARDEGNA. I think it is important to start out and understand that right now, under current regulations, you look at the total plan, and the prohibited group is matched against the total benefits in the plan.

What the Treasury is proposing is that, instead of looking at the total group, you create various cells. So let's take a standard plan.

The CHAIRMAN. And compare each cell to itself?

Mr. SARDEGNA. Each cell to itself. So in a standard plan, if you have single employees, single with spouses, single and family, and then you run those three against a medical plan, a dental plan, you can see each one of those creates its own cell. So in a standard plan it is likely that you can get five up to maybe 15 cells.

Now, if you go to a flexible benefit plan and, instead of having only one medical plan against either a single person or let's say a family group, you now have four choices for medical plans, three choices for life plans.

We did some very rough calculations, and you could easily have 50 cells.

Now, you can see what can happen if you have a group of 10,000 employees and you are dealing with 50 cells, you might be able to make it workable. I doubt it, even then. But as you go down in size to groups of 200 and 100, with the possibility of 50 cells, you have rendered the plan virtually unworkable.

The CHAIRMAN. You mean you have such a small sampling that nothing is relevant?

Mr. SARDEGNA. Well, what could happen to you, Senator, is you might have a situation where if you look at the total plan you could have the prohibited group clearly within any kind of discrimination rules, but you might have three people in the prohibited group and only one person in the nonprohibited group in one of those cells. And that could be compounded many times over, because the Treasury proposal focuses on each of those cells as a separate plan. We don't think that that was the intent in terms of undermining the 125, but it has that practical effect.

In actually dealing with the employer, you would be in the position of not being able to tell the employer, before he entered into the plan, whether or not his plan was going to qualify.

The CHAIRMAN. Because it would depend upon how the employees reacted?

Mr. SARDEGNA. That's right. And then each time he would have to go through reiterations. And by the time he was through the 13th reiteration he would say, "We don't want any choice here." And that is the practicality of what we are dealing with.

The CHAIRMAN. Now, do you also run the possibility of discrimination on a health plan if younger, single employees, for whatever reason, choose a particular kind of coverage and older married employees with dependents choose another, and you get therefore a disproportionate number of your higher paid employees choosing more expensive insurance? Would that rank as discrimination in your judgment in the Treasury's plan?

Mr. SARDEGNA. Two aspects there. Again, our proposal was to try to make sure that in some way each individual in the plan would have the financial capability of purchasing the most expensive benefits; we would have some relationship so that they would have either dollars or credits to purchase it. Now, they should make their choices on the basis of their own economic needs. For example, is it nondiscriminatory if you have two working spouses, they work in different places, they both have medical plans, and one decides now not to have a medical plan, but economically it makes sense for them? So we don't think that that in and of itself represents discrimination; but to have the financial capability of making the choice is the key, then allow each individual, based upon their financial needs and their own social needs, to make the choice.

THE CHAIRMAN. You write a lot of cafeteria plans.

Mr. SARDEGNA. Yes, we do.

THE CHAIRMAN. Explain to me how the employee becomes a consumer when faced with a cafeteria plan from which they have choices for different benefits.

Mr. SARDEGNA. OK. One of the key aspects—and of course this is one of the key aspects underlying, hopefully, the use of cafeteria plans for cost containment. Right now in the current system the problem has been that the consumer of the benefit, namely the sick person in this case, has had no opportunity to participate and is in fact sheltered from any of the financial consequences of his or her decision.

In a cafeteria plan, what happens is that individuals start making choices relative to medical plans. The way it generally works is that they will start choosing—and it has been proven as time has gone on—plans with higher deductibles, higher coinsurance factors. They become involved in the process. They now consider these employee benefits, which in the past many of them have never understood, as dollars that are theirs, for the first time.

In standard plans, in most cases the employee doesn't even recognize the value of those benefits. In flexible plans, you make that a valuable option, because now you have choice. You can even take it out and make it taxable. That is the key element, we think, in helping cost containment.

THE CHAIRMAN. Senator Durenberger?

Senator DURENBERGER. Thank you, Mr. Chairman.

I would have introduced Mr. Pratt, because I have known him for 20 years in Minnesota. In his direct capacity he is the director of taxation for a company that you love so much, because they pass out the tax-exempt fringe benefits right and left. You are famous for telling the story about how they have automobile repair and just about everything else at General Mills. So I wasn't sure whether I should associate myself with it or not.

THE CHAIRMAN. Which is not yet a fully paid employee fringe benefit, however.

Senator DURENBERGER. No, not quite. No, I'm sure you draw the line short of that. [Laughter.]

From the view of large and the medium I would like both of you to speak to us and the small employees. Just pick up on the last question the chairman asked, Mr. Sardegna, about flexible benefits in cafeteria plans.

I get the impression that a lot of people would like a real flat tax in this country, which means that employees get paid in cash and then make their choices on benefits after they have paid tax on that cash. That would be a literal flat tax. No freebies for anybody. If we don't get to that, then Treasury and the IRS would like to decide today that life insurance is good but day care is bad, and so much legal service is OK. And that is implicit in some of the recommendations that Mr. Sardegna talked about.

My first question is, What would happen, as you look across employment in America today, if we paid everybody in cash and got rid of the subsidies for fringe benefits? Might it literally happen that people would stop buying health insurance or life insurance or day care, or whatever? I am not advocating that position, but——

Mr. SARDEGNA. It is our opinion that if in fact that were to happen, many people out of necessity, particularly in the lower to middle income categories, would make the choices for food, shelter, for a whole series of other choices, economic choices. That would result in them not being covered. Someone would have to cover them. That would eventually be either the State or the Federal Government. The net result is that in part you would strip some people of their dignity, you would in effect perhaps result in larger expenditures in the Federal Government when you net out the cost of providing that coverage versus whatever you could get from the taxation of those benefits. We think it would work against public policy, clearly. We feel that the current plans are in fact working and that what we should try to do is to increase the value to the employees by giving them choice.

Senator DURENBERGER. And section 125 of the code is probably the best place to go to look for choice, is it not?

Mr. SARDEGNA. That is correct.

Senator DURENBERGER. Because literally, as you indicated in your response to the question before, that brings the person online about their disability, their health, their family, and they start making choices more judiciously?

Mr. SARDEGNA. That is correct. Currently, most of the fixed plans in force right now reflect the demographic distribution in this country of like two adults and two point something children. Well, that represents less than probably 12 to 15 percent of the total population. And a lot of those benefits are being wasted and are not being put to effective use; 125 permits them to be put to effective use.

Senator DURENBERGER. That's right. Now, let me take it one step farther: Not everybody needs $3,000 a year worth of health insurance, life insurance, something else. So they ought to be permitted to take back cash, or they ought to be able to get an extra credit against their 401(k) or retirement. Doesn't that make some sense, too?

Mr. SARDEGNA. Yes, it does. And it also might actually result in increasing the revenue to the Federal Government.

Senator DURENBERGER. How would that happen?

Mr. Sardegna. Well, if they take cash, they turn what is an essentially nontaxable benefit into a taxable benefit. No one can tell because we do not have a long enough period of experience with 401(k) plans, but it is our personal feeling that over the long term you might even get some revenue from this as opposed to keeping it without flexibility.

Senator Durenberger. But wouldn't the ideal situation be where we would put all of these nonretirement pension related benefits into 125 and just let people, employers and employees, make choices among these benefits, without saying you can only have so much of this and so much of that?

Mr. Sardegna. Senator, you would make a great salesman for us; we totally agree with you. It makes a great deal of sense in terms of meeting the needs of the employees and also the Federal Government.

The Chairman. Dave, you wouldn't believe this, but last year when we had the agreement on the cafeteria plans, Barber Conable and I proposed just this, that if you didn't use up all of your benefits you could take it in cash, but then you had to pay a tax on it. Treasury was opposed.

Senator Durenberger. I believe that.

The Chairman. Otherwise, you carry them forward, so it is noncash, and the Treasury loses in that case, when you carry them forward. They did not like the idea of them being able to take them back in cash and receive—who knows how much money they might have received?

As long as we have Mr. Pratt here, I just can't resist telling the story about General Mills.

Senator Durenberger. Oh, God, why did I bring that up? [Laughter]

The Chairman. I was making a speech one time on my favorite theme of employee benefits, and I said to this group of 300 or 400, "But you know, what you really ought to do and the thing that bothers your employees more than health or anything else is taking care of their automobiles, and you ought to provide them with auto care." Afterward this fellow comes up to me and says, "Senator, you won't believe this, but our company has auto care." And I asked him who he was, and he said he was Paul Parker, and that he was a vice president of General Mills, and they had moved their plant way out, 25 to 30 miles out from Minneapolis/St. Paul. Well, when they put it there it was a long ways out—it has grown a lot now—and they had too much downtime. The employees were coming to work late because they were leaving their cars, and then they were leaving work early to go and get their cars. So they put up an auto-repair facility on their parking lot. The employees could bring them in. They charged them the cost over the mechanics, who were General Mills employees. They got us parts at cost, and it was 20 or 30 percent less than being repaired elsewhere.

I asked him how the employees liked it. He said, "Like it? We could get rid of vacations and health insurance before we could get rid of auto care." [Laughter.]

The Chairman. I am not recommending that yet for inclusion in the cafeteria plans.

Senator Mitchell.

Senator MITCHELL. Thank you, Mr. Chairman.

Mr. Sardegna, in your testimony you said that the probability of disqualification increases for cafeteria plans as the size of the employer decreases. Are you saying that small employers are the most likely to be impacted by the proposed nondiscrimination rules of section 125?

Mr. SARDEGNA. That's right, Senator. And as we talked about before the reason is, because there are so many possible cells, the fewer number of employees you have to spread over those cells, the greater the probability that you would not qualify. So when I mentioned in the testimony that it was inequitable and unfair treatment, in effect anyone in 125 but particularly those for small employers would be unequitably treated compared to large employers and compared to people in standard plans.

Senator MITCHELL. So you would have to reduce the number of options—that is, the flexibility of the plan—as the size of the employer decreases, to make it workable?

Mr. SARDEGNA. That is right, which in effect would render the whole idea of 125 inoperable.

Senator MITCHELL. Do you believe section 125 helps cost containment, and if so how?

Mr. SARDEGNA. I do believe it helps cost containment, and I do believe it does that by introducing the individual consumer into making the choice, and therefore that choice becomes an economic benefit or hindrance to that person. And once you get the person into the cycle—and the person is not in the cycle now—we have found, and there is plenty of evidence, that once you do that you start to take care if the inequities in the system.

The current system shields people from the costs of medical insurance.

Senator MITCHELL. Well, when you say "get them into the cycle," what you really mean is making them pay part of the bill?

Mr. SARDEGNA. They would make economic choices. They would be paying part of the bill, such as the increase in nondeductible features and coinsurance features, which are now being done even in standard plans. They do pay part of the bill.

One of the aspects that we think 125 provides is that the cost of medical insurance is increasing rapidly for employers. They are being forced and have taken actions. They are faced with having to take away benefits from employees if in fact that want to introduce the concept of either greater coinsurance factors or participation. That is a very difficult thing to do. Section 125 provides a vehicle where they can give a benefit choice in return for the fact that the employer may pay more as it relates to that medical plan, but he would have still the funds to look for other choices that were more to his economic benefit or more fit his circumstances. It provides a vehicle for that to enter the systems; otherwise, you are taking away benefits, and that is very raely done without a great deal of disturbance, as I think everyone probably recognizes.

Senator MITCHELL. In your experience with cafeteria plans, is there a difference between the benefits chosen by high income earners as opposed to the lowest income earners, generally?

Mr. SARDEGNA. I might have to ask some of my experts here for that.

[Pause.]

Mr. **Sardegna**. Generally speaking, we don't have enough data to show one way or another, and I'm not sure that there is enough data in total. However, again, going back to the example I described before, medical plans are not income related. The amount of premium is based upon incidents, it is based upon age, and it is based upon sex. So unlike many of the other employee benefits which have some relationship to income, the cost is the same regardless of income. And that is an important aspect. So therefore, the individuals make various economic choices. But their incidence of medical is aside from economics.

Senator **Mitchell**. Thank you.

Thank you, Mr. Chairman.

The **Chairman**. Senator Heinz.

Senator **Heinz**. Thank you, Mr. Chairman.

Mr. Sardegna, one of the issues that we have tended to focus on with respect to employee benefits and pensions in particular, is whether people at the top are getting too much. In the process, we tend to lose sight of an equally important question, namely, are people down below getting adequate coverage? As a result, over the years we have, in this committee specifically, tended to question only if the rich people getting richer? Or are we losing too much revenue?

The other policy consideration concerning adequate pension coverage for the people who probably need it most, tends to get very much overlooked. I think it is not because of any intention, but people somehow feel that if we keep the rich from getting too much, everything is going to be all right down below. I don't buy that. That, I believe, is just a way of making people a little less vulnerable to political criticism.

Now, you support the philosophy of broad nondiscriminatory coverage in exchange for tax-free benefits, and indeed, if we are going to hang on to tax-free benefits, we had better find a very good case for them, based on helping the people who need it the most, and not the people who need it least.

Now, would a simple coverage rule achieve this goal? For example, one that required all middle and lower paid workers to be covered under a plan which is comparable for all employees? Would that be too difficult to administer, or could we do it?

Mr. **Sardegna**. Senator, could you describe what you mean by "comparable" ?

Senator **Heinz**. I suppose the best way of saying it is that, the coverage would be the same within a division or section of a company, but it could vary among different divisions. I guess the way I would look at it is, if General Motors bought General Chewing Gum which was a little company that had a different kind of plan, but had broad coverage of its employees.

Mr. **Sardegna**. They are buying everything else.

Senator **Heinz**. That plan would different from General Motors plan, and there would be no obligation to make it the same as General Motors plan. Does that help you understand what I am talking about? The idea would be that the rule for broad coverage would be everybody below the Social Security maximum would have to be covered in a plan if they had been there long enough, and worked enough hours—or some other kinds of obvious qualifications such as the kinds of rules we have today.

Mr. SARDEGNA. What I am interpreting from what you are saying, Senator, and I want to be careful that I understand the question, it is that you are saying between divisions or maybe even between industries there should be some comparability.

Senator HEINZ. Well, I am trying not to say exactly that. What I am trying to say, is I think there should be coverage of all employees in a division who meet a certain test; but there need not be uniformity between various divisions.

One of the problems I am aiming at is that under current law there are a number of loopholes. One big one, for example, is that you can cover in the same division, one class of employees with a pension and another without as long as it doesn't discriminate in favor of the highly paid. Yet those people can be working side-by-side, can be working the same number of hours, et cetera. And if there is some technical distinction, such as one group of employees is being paid hourly and the other is being paid salaried, you don't have to give the hourly a pension.

Mr. SARDEGNA. I am thinking about that.

Mr. PRATT. Well, the thing that occurs to me is that, when you have collective bargaining, of course you are dealing with a union that may or may not want the same kind of coverage that you give to salaried employees, and I can see a distinction there that somehow you would have to deal with.

Senator HEINZ. Chances are, wouldn't the unionized employees be in a different unit, though?

Mr. PRATT. Well, I thought you meant by a "broad unit" a division or a subsidiary company.

Senator HEINZ. No, not necessarily. I am thinking of the accounting department versus manufacturing, too.

Mr. PRATT. If you remove the bargaining units from that, I think it probably makes some sense.

Senator HEINZ. You could carve out the collective bargaining units, no problem.

Mr. PRATT. Like most things, when something is as broad and global as that proposal, I think we would have to think about it a little bit before we respond.

Senator HEINZ. All right, please do.

I thank the Chair.

The CHAIRMAN. Senator Long.

Senator LONG. No questions, Mr. Chairman.

The CHAIRMAN. Senator Durenberger.

Mr. SARDEGNA. Senator, we would be happy to think about that and offer some written comments to you on that.

Senator HEINZ. I would appreciate that.

Mr. SARDEGNA. We would be glad to do that.

Senator DURENBERGER. Mr. Sardegna, do you know what the annual premium costs are for your employees for health insurance?

Mr. SARDEGNA. On average I can give you some ranges. Generally speaking you come out with an average in the area of $1,500 to $1,800.

The CHAIRMAN. Do you mean the employees in their company?

Senator **Durenberger**. Yes.

Mr. **Sardegna**. Oh, in our company?

Senator **Durenberger**. For your company.

Mr. **Sardegna**. Specifically, I don't know.

Senator **Durenberger**. You don't know?

Mr. **Sardegna**. For Union Mutual per se?

Senator **Durenberger**. Right.

Mr. **Sardegna**. No, we keep hands off, you see. We underwrite that, and we have to keep a Chinese coat between us.

Senator **Durenberger**. Do you know what the average was last year, or is somebody behind you going to find out?

Mr. **Sardegna**. I can tell you what the average is if you look across a broad section of the United States. It is $1,500 to $1,800.

Senator **Durenberger**. And do you know approximately what your company is? I am not trying to pick on you, but——

Mr. **Sardegna**. It is about $1,500, my x-rays tell me.

Senator **Durenberger**. Well, the low side of the average. [Laughter.]

Of your clients in Portland, ME, which one do you think is probably the lowest? Would $1,200 for a family plan be on the low side of the premium? Or $1,000 a month? You deal with a lot of small companies.

Mr. **Sardegna**. Yes, we do deal with a lot of small companies. I would say that that is about right, Senator.

Senator **Durenberger**. What, $1,000 or $1,200?

Mr. **Sardegna**. I would think that that is true, for the lowest.

Senator **Durenberger**. OK.

You said earlier in response to a question—I think it was Goerge's question—that the cost of health insurance is unrelated to income, to the best you knew. It was related to age and sex, and I think we know it is also related to previous health condition in some cases.

Mr. **Sardegna**. It is also geographic considerations.

Senator **Durenberger**. And the average community cost of health care, in some way.

Mr. **Sardegna**. Yes.

Senator **Durenberger**. That is really what it is. So if you take a 30-year-old male in Portland, ME, that person's cost is going to depend on whether thay are a male, and whether they were 30 years old or some other age, and so forth, not on who they work for.

Mr. **Sardegna**. Not on who they work for but on how much money they make.

Senator **Durenberger**. Right.

But the fact is that in your company the government helps to pay your employees a portion of their $1,500 a year health insurance. In some other small company in Portland, ME, it might be as low as $1,000 a year. And in Detroit, Lee Iacocca who makes $5 million a year gets $3,300 by way of a premium.

Now, just as a citizen, how would you characterize that as a way for the government to reimburse people for health care?

Mr. **Sardegna**. If you are talking about the question of horizontal equity?

Senator DURENBERGER. Well, I might talk about horizontal equity; I might talk about it in terms of a $2 trillion national debt; I might talk about it in terms of high interest rates or a $225 billion deficit—I could approach it in a variety of ways. I am asking the question: As a citizen who believes in fairness in the Tax Code, does it look fair to you that a lot of United Auto Workers making $20 an hour, including their president who makes $5 million a year, ought to get a $3,300 a year subsidy when, in Portland, ME, there are a lot of people "ain't getting anything" by way of health care? And in Minneapolis, MN.

Mr. SARDEGNA. Yes.

Thinking about that as a problem, I would go back to what are you trying to accomplish from a public-policy point of view. And if in fact what you are saying is—and I believe it to be true for employee benefits—that this is a valuable benefit, the reason and the incidence of why it varies is not based upon any kind of a decision made by people based upon income, but it is determined by "you happen to live in Detroit as opposed to living in Portland, ME; you happen to be a certain age," and so forth. You are still meeting the fundamental economic need, and it reflects, it is a true reflection of, the circumstances. I as a citizen feel less concerned about that than if I find out that individuals are making some sort of unreasonable choice to benefit just a small group of people. I feel personally that there is a benefit to the total society to have employee benefits and to support them, because I think it is good for the total country.

Senator DURENBERGER. Then you wouldn't have any objection to extending by way of a tax credit this same benefit to self-employed persons and people who don't work for your company or for Chrysler, if we would just change the legislation so that everybody gets access to $3,300 a year? If Iacocca can get a $3,300 a year subsidy, why shouldn't everybody in the country, and we will just work it as a credit against their tax liability? Would that be fair?

Mr. SARDEGNA. I haven't thought specifically about that. But again, I go back to the fundamental philosophy we are talking about: It is ggod punlic policy so long as it is done so that it is nondiscriminatory and we are in fact reflecting the realities of the situation.

Remember, fundamentally, employee benefits and the cost of them are an attempt by employers to attract and retain employees. And that has to be factored into the entire equation.

Senator DURENBERGER. OK. Thank you.

Thank you, Mr. Chairman.

Senator MITCHELL. Mr. Chairman, I have one more question.

Mr. Sardegna, how would the proposed tax—$10 a month or $25 a month, now pending before this committee on health care benefit premiums—how would that affect the sale of plans, specifically, cafeteria plans?

Mr. SARDEGNA. How would that affect it?

Senator MITCHELL. What would be the effect?

Mr. SARDEGNA. Quite honestly, it doesn't affect it at all. It doesn't have any negative impact or positive impact. So, as it relates to the difference between cafeteria plans versus fixed plans, there is no difference.

Senator MITCHELL. How about all plans? Would it have an effect on plans generally? Do you support that provision in the President's proposal?

Mr. SARDEGNA. First of all, let me state that I feel that employee benefits in general should not be taxed. Now, having said that, let me be responsive to your question.

Senator MITCHELL. Well, that's an answer.

Mr. SARDEGNA. Well, you asked me a specific question, and I wanted to be as responsive as possible. I do not feel they should be taxed. Floors, like the one being proposed now, again have to be measured against policy. If your intention is to raise revenue, I think this floor does it very well. If your intention in addition to raising revenue is to do something about cost containment, this is probably not the way to go.

The CHAIRMAN. Any other questions?

Senator HEINZ. Mr. Chairman.

The CHAIRMAN. Go ahead.

Senator HEINZ. Mr. Pratt, you testified before I arrived, but it is my understanding you made a suggestion that we ought to allow at least a $2,000 minimum contribution to a 401(k) plan. Is that right?

Mr. PRATT. That is right.

Senator HEINZ. That suggestion intrigues me, because what you are really doing is treating IRA's and 401(k)s in a very similar fashion, almost equally and uniformly. That suggests to me that maybe we should consider coordination between IRA's and 401(k)'s. Wouldn't it make some sense to let everyone make a $2,000 a year contribution to their choice of an IRA or their 401(k), if they have one, and then if they contribute $2,000 to a 401(k) and want to contribute more, then they can go up to the 15 percent of compensation or whatever. Would you object to that kind of an approach?

Mr. PRATT. Senator, the biggest problem with that, I think, is the administration. The 401(k), of course, is an employer plan. The IRA can be an employer plan but it may not be. The present proposal has elements of what you are talking about in that it has an $8,000 limit against which you have to offset IRA contributions. Our benefits people say that from an administrative standpoint it is very difficult to know whether somebody has an IRA or not. I don't know whether somebody would have to file a certificate or do something with respect to their contributions. If you were going to integrate those things, you may have to integrate a nonemployer plan with an employer plan. So, the practical solution that most people would have, is merely to, rather than the limit being——

Senator HEINZ. I understand your concern about the administrative difficulties, but how about doing it the other way around, then?

Mr. PRATT. Do you mean if you contribute to a 401(k) that reduces your ability to contribute to an IRA?

Senator HEINZ. Yes.

Then the individual has the problem with the IRA, but the employer doesn't.

Mr. PRATT. That would certainly, from a company standpoint, make it easier to do.

Senator HEINZ. Let me ask you another question on a different subject; it has to do with the combination of taxes on IRA distributions. We have a 10-year forwarding average. And it results in very favorable tax treatment for someone who takes the lump sum, and spends it, compared to someone who draws their pension as an annuity.

For example, the tax rate on a $10,000 lump sum under 10-year averaging is about 5.5 percent. That is because we don't take into account any other income that person might have.

If the goal of the policy is to encourage retirement savings, does it make sense to you that we encourage young people in effect to spend? Seventy percent of all the people who get these distributions spend them, they don't even invest them in a house in any way, shape, or form. Does this policy make sense to you, that we have a set of rules that allows or encourages spending, not saving?

Mr. **Pratt**. Right. When you have a flexible system, sometimes it is going to encourage people to do the wrong thing. The real question you have to ask is: What does it really do for the retirement security of people in this country on the whole.

Senator **Heinz**. My feeling is, the reason we have these kinds of tax-favored benefits is to provide for retirement security. And if something happens to them on the way where they don't, the whole rationale for what we are doing fails.

Mr. **Pratt**. That would be true if that were the invariable consequence, but it isn't.

Senator **Heinz**. It is not the invariable consequence, but it is the consequence 70 percent of the time, from what we know.

Mr. **Pratt**. What most people do when they take a lump sum distribution on retirement is invest it. Normally, when you have a defined-benefit plan, once you retire you are pretty well set with that pension. In the private sector we are ordinarily not indexed for inflation. Now, in order to protect a person from inflation, they do need supplementary investments, and one of their——

Senator **Heinz**. I think I understand where you are coming from, but I have a different question I want to ask and I am about to run out of time.

Under current law or what the President proposes, couldn't someone at retirement age roll their lump sum into an IRA and draw it out over 10 years to avoid tax?

Mr. **Pratt**. As I understand it, that is one of the options, to roll it into an IRA, and that may or may not be a good choice.

Senator **Heinz**. But whether it is a good choice or not, couldn't someone do that and by doing it, drawing it out over 10 years, avoid any tax?

Mr. **Pratt**. I'm sorry?

Senator **Heinz**. Couldn't someone take the lump sum distribution, put it into an IRA, as proposed, draw it out over 10 years, and avoid any tax?

Mr. **Pratt**. That could be possible, but it isn't something that should be encouraged. Drawing it back ovr 10 years is a lot different from drawing something at one time.

Senator **Heinz**. Oh, I am not arguing that; I am just trying to get a yes or no answer to the question.

Mr. **Pratt**. I think that is possible.

Senator **Heinz**. OK, thank you.

Mr. **Pratt**. I'm sorry I misunderstood you.

Senator HEINZ. No, excuse me.

The CHAIRMAN. Gentlemen, thank you very much.

Now we will move back to Bob Georgine, president of the building and construction trades department of the AFL-CIO, and when he is done we will go on with the panel that follows him. I would say to the witnesses here, we will run right through the noon hour if necessary—we will not break—so that we can finish without having to come back this afternoon.

Mr. Georgine, good to have you with us. You've got a couple of strangers with you.

STATEMENT BY ROBERT A. GEORGINE, PRESIDENT, BUILDING & CONSTRUCTION TRADES DEPARTMENT, AFL-CIO, WASHINGTON, DC, ACCOMPANIED BY PAUL S. BERGER OF ARNOLD & PORTER, AND JACK CURRAN, LEGISLATIVE AND POLITICAL DIRECTOR, LABORERS' INTERNATIONAL UNION OF NORTH AMERICA AFL-CIO

Mr. GEORGINE. It is nice to be here, Mr. Chairman, I have with me Jack Curran and Paul Berger.

The CHAIRMAN. You have a loud voice, but pull that microphone right up close so the people in back can get the benefit of your comments.

Mr. GEORGINE. OK. Shall I reintroduce Jack Curran and Paul Berger?

The CHAIRMAN. I think most of us here know them.

Mr. GEORGINE. Mr. Chairman, the NCCMP and its affiliates care deeply about the recent legislative trend to cut essential employee benefit tax incentives. Some seek to justify this trend in the name of "tax reform." The more likely explanation for the trend is the overall attack on Federal budget deficits. But whatever the cause, we fear that these crucial programs may be destroyed in the process.

We appreciate the position that you have taken, Mr. Chairman. Your staunch support and protection of employee benefit programs has been outstanding. But we must continue to work together until all of our legislators understand the importance of favorable tax treatment to the continuation of these very crucial benefits.

Unfortunately, Congress has recently dealt with these essential programs on an ad hoc, piecemeal basis. This trend threatens an irrational crazy-quilt of rules which will destroy the carefully conceived employee benefits structure. Any additional changes should be made rationally within the context of a responsible national employee benefits policy.

As to attacking budget deficits in this manner, my views are simple. Attempting to balance the Federal budget by reducing or eliminating important employee benefit programs—programs that are essential to the health and security of working Americans—is fundamentally wrong. It would also be counterproductive in the long run, since expensive new Government programs would likely be required if these private sector programs were to dry up.

Now, for these reasons the NCCMP and its affiliates strongly oppose any tax on employer-paid health care benefits, whether structured as a cap as the Treasury originally proposed, or as a floor as the President now proposes. Regardless of its form, a tax on health care benefits would likely destroy many private health care programs.

In collectively bargained plans, a decision to begin or continue health benefit programs is made for a group rather than for each individual. If increased tax burdens make health benefits more expensive, the younger and the healthier workers who think they will never need care could well ask their bargaining representatives to support the termination of health benefit programs. These workers' first priority is their most immediate needs—housing, food, and clothing. Many have little or no discretionary income with which to purchase taxable health care benefits. Faced with the alternative of reduced wages or elimination of taxable health benefit programs, many younger workers will choose the latter.

On the other hand, older workers and workers with health problems will want the continued opportunity for employer-paid health care coverage. Some of these workers may be uninsurable on an individual basis or insurable only at prohibitive rates. The fact is that, given these different and often competing needs, for the Federal Government to place an additional financial disincentive for workers to continue or commence a collectively bargained health plan is to add additional strains on the bargaining process. Those strains will make it more difficult for collectively bargained plans to obtain the funding they need to provide benefits which would otherwise be unavailable. If good health benefits are not provided by the private sector, workers will be forced, through no choice of their own, to fall back on government programs.

Both the cap and the floor would fall harshly across a broad cross-section of multiemployer plan participants. Lower paid workers would be among those adversely affected by a cap, since high health coverage costs in multiemployer plans are not necessarily linked to high income levels for covered employees. In addition to hitting those with comprehensive coverage, the cap would discriminate against those living in high-cost areas where the same basic coverage is more expensive than elsewhere, as well as older groups, groups with retire coverage, groups in declining industries, and groups that provide extended coverage to unemployed workers' families. Moreover, a health care cap would prompt the elimination of such protections as preventive health, dental, mental health, vision care, prescription drug plans, diagnostic programs, and outpatient services.

The proposed tax floor also discriminates by taxing everyone on the same flat dollar amount regardless of income or the character of coverage. Three hundred dollars in additional taxable income will obviously be tougher on a low-wage earner and will represent a bigger piece of less comprehensive benefit packages.

One of our greatest concerns is that any tax on these essential benefits could easily prove to be the proverbial camel's nose under the tent. Mr. Chairman, I am not suspicious by nature, at least not of our Government's policymakers, but nonetheless it would be all too easy to increase any floor in future years where revenues were desparately needed. Similarly, any health care cap could be lowered. In any event, a cap-type tax would increase automatically unless the cap were indexed to fully reflect increased costs.

Finally, Mr. Chairman, I wish to touch briefly on a positive aspect of the President's proposal. The NCCMP strongly supports making the current exclusion for employer-paid group legal service permanent. As the leading congressional champion of legal sevices plans, you must be pleased, Mr. Chairman, at the growth and success of these plans over the last 9 years. From fewer than 100,000 covered employees in 1976, legal services plans have grown to cover 13 million Americans. Without these important programs, many American workers and their families would be denied access to the legal system and would lose some of those protections which form the foundation of a free society.

I have included discussions of other important provisions of the President's proposal in my written testimony, and I thank you for listening to me, Mr. Chairman.

[Mr. Georgine's written testimony follows:]

National Coordinating Committee for Multiemployer Plans

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TESTIMONY OF ROBERT A. GEORGINE, CHAIRMAN,
NATIONAL COORDINATING COMMITTEE FOR
MULTIEMPLOYER PLANS

BEFORE THE SENATE FINANCE COMMITTEE

July 19, 1985

1. Introduction

My name is Robert A. Georgine, and I appear here today in my capacity as Chairman of the National Coordinating Committee for Multiemployer Plans.

The Coordinating Committee was organized, shortly after the passage of ERISA in 1974, to represent the interests of the more than eight million working men and women, and their families, who are covered by multiemployer plans. The Committee's affiliates include more than 140 pension funds, health and welfare funds, and related international unions.

The NCCMP and its affiliates are deeply concerned by the recent legislative trend toward (1) proposing elimination of tax incentives for essential employee benefit programs under the misnomer of "tax reform"; and (2) attacking federal budget deficits through the imposition of additional tax burdens on these essential programs. We are afraid these crucial programs will be destroyed if this trend continues.

Mr. Chairman, we know you are a staunch supporter and protector of essential employee benefit programs and have worked long and hard to stop this dangerous trend. We deeply appreciate your efforts. But we must work to educate other legislators on the importance of continuing favorable tax treatment for these crucial benefits.

The benefits provided today through collective bargaining or pursuant to federal or state legislation are the hard-won product of years of struggle. These benefits are essential to the financial security and physical well-being of working men and women and their families, who could not otherwise afford them. These programs provide essential protection against illness, forced early retirement, unemployment, and other tragedies or contingencies that interrupt their earning power. They provide income to permit retirees to live with dignity, and without burdensome dependence on the public sector. They also provide working Americans and their families with meaningful access to the legal system and protections that form the foundation of a free society.

Congress has long recognized the importance of these programs to our society. That's why it provided favorable tax treatment to encourage their growth and development. These modest incentives have been very successful in getting private sector employers to provide essential benefits to a broad cross-section of employees, especially lower-paid workers. More than seventy-five percent of those earning pensions in 1983 had annual salaries of less than $20,000. Of those with employer-paid health insurance, 80 percent earn under $25,000 per year. Health insurance is provided by employers to nearly 80 percent of all public and private workers and term life insurance coverage is virtually universal. Thus, the vast majority of employee benefit recipients are lower and middle-income individuals, who rely on their employer-paid benefits for their own and their family's security.

Unfortunately, the recent legislative trend has shown an inclination to deal with these essential programs on an ad hoc, piecemeal basis in the context of so-called "tax reform" or deficit reduction. If this trend continues, we will end up with an irrational crazy quilt of rules.

The tragic result will be the step-by-step destruction of our nation's carefully conceived employee benefits structure. We can't just keep piling complicated rule on top of complicated rule without careful consideration of their impact on achievement of employee benefits policy and goals. Before we make any more changes in the employee benefits area, we have to make responsible decisions about what our nation's employee benefits policy and goals are. We have to analyze the available options for achieving these goals, including the effectiveness of utilizing tax incentives. The House Ways and Means Committee is going forward with hearings on these issues. Senate hearings on these issues should also be scheduled. Let's stop making employee benefits decisions in an irresponsible, piecemeal fashion and begin making them rationally within the context of a responsible national policy.

Elimination of tax incentives for essential employee benefit programs does not constitute the closing of any "loophole," and does not serve any of the other goals generally advocated as "tax reform." There may be social policy questions on whether certain employee fringe benefits, such as employer-paid meals, serve sufficiently important social purposes to justify the erosion of the tax base associated with their exclusion from employee income. However, essential employee health, welfare and pension programs are not properly subject to such an argument. In considering whether elimination of tax favored treatment for a particular type of benefit would constitute "tax reform," you must consider in each case the social purposes served, available alternatives for achieving those purposes, and the consequences of eliminating the favorable tax treatment.

Attempting to balance the federal budget by reducing or eliminating the favorable tax treatment supporting essential employee benefit programs so important to the physical and financial well-being of working Americans is fundamentally wrong. It is also counterproductive in the long run because federal budget deficits would actually be increased by the need to fund new and expanded government programs to replace private sector programs.

The argument that some tax revenue has to come from the basic employee benefit structure is also unfair. Employees who rely most heavily on essential employee benefit programs are likely to be least able to afford increased tax burdens. Taxing their essential benefits is unfair, especially when special tax treatment remains available for taxpayers who could better afford increased tax burdens, like the oil and gas industry.

It would also be unconscionable to subject these essential benefits to FICA and FUTA tax. These are regressive taxes that fall most harshly on the lower-paid workers who rely most heavily on employee benefit programs. These programs tend to provide the types of benefits that would otherwise have to be provided through government programs such as Social Security and federal and state unemployment. They take pressure off government programs. Thus, it would be counterproductive to transfer a portion of their funds and the responsibility for providing employee benefits to government programs.

The President's proposal contains several provisions which would impact harshly on employee benefit programs. Even more draconian changes in the law have been proposed by others. In our view, the correct course is simple: No additional taxes on essential employee benefit programs.

2. Tax on Employer-Paid Health Care Benefits

The NCCMP and its affiliates are strongly opposed to any tax on employer-paid health care benefits, whether structured as a "cap," as Treasury proposed, as a "floor," as the President has proposed, or otherwise.

If the direct cost of health insurance benefits were increased through increased tax burdens, regardless of their form, the younger and healthier workers who feel they are least likely to need such benefits would likely drop out of plans. This would be especially true of low-income workers who simply cannot afford the additional cost. As their participation ended,.the cost for the remaining workers would increase and eventually become prohibitive. The end result would likely be the destruction of many such plans. Even before this, a health care cap would prompt the elimination of such protections as preventive, dental, mental health, vision care, prescription drug plans, diagnostic programs and out-patient services.

This devastation would come about even more quickly in collectively bargained plans. In such plans, individual workers cannot opt out individually. The decision not to bargain for such benefits is made by the collective bargaining representative for the group. Thus, the younger workers may likely vote to terminate health benefit programs. These young workers are faced with tough economic choices. Their first priority will necessarily be to satisfy their most immediate perceived needs like housing, food, transportation, and utilities. Many of these workers, especially the lower paid workers, have little or no discretionary funds they can choose to allocate to a tax on health care benefits, let alone to the cost of the benefits themselves. This is particularly true in the current economic climate, when many employers are reducing wage packages. Faced with the alternative of accepting further reduced wages or eliminating taxable health benefit programs, many younger workers will feel that they simply cannot afford to pay for taxable health benefits they do not expect to need in the near future.

As a result, older workers and workers with health problems may lose the opportunity to obtain health care coverage through employer-paid programs. The cost of providing medical benefits increases dramatically with increased age of covered workers. For example, the cost of providing medical benefits to workers age 44 and under is only 80% of the average cost of providing benefits to all employees. This percentage increases with age to 112.5% for employees age 50 to 54, 125% for employees age 55 to 59, and 160% for employees age 60 to 64. Thus, many of these workers will be uninsurable on an individual basis or will find it impossible to obtain health insurance coverage at affordable rates. Through no choice of their own, thev will be forced to rely on government programs. And just as important, the different goals and needs of older versus younger workers are likely to put additional strains on collective bargaining if the government forces workers to make these choices. Those strains will make it more difficult for collectively bargained plans to obtain the funding they need to provide benefits which would otherwise be unavailable.

Without new or expanded government programs, families stricken by illness could be left with no means of obtaining basic health care. Private sector programs provide over $80 billion per year in essential health protection, for a tax expenditure of only about $18 billion. Without these private sector programs, the government could well be required to spend all of that $80 billion directly.

Both the "cap" and the "floor" would fall harshly on a broad cross-section of multiemployer plan participants. A national actuarial consulting firm has recently completed a study of the 494 multiemployer welfare plans on which it has complete data. That study estimated that nearly half of the 1.4 million participants in those plans would have had to pay additional tax, averaging more than $150, if the Treasury's proposed tax cap on coverage exceeding $175 per month for a family or $70 per month for an individual had been effective in 1984. The study projects that, by 1989, almost 375 -- over three-fourths -- of such plans, covering more than one million employees, would be over the "cap."

Lower-paid workers would be among those adversely affected by such a "cap." High health coverage costs in multiemployer plans are not necessarily linked to high income levels for covered employees.

Low-paid workers are often covered by multiemployer health plans that provide them a comprehensive benefit safety-net. Per-employee costs may be high in a multiemployer plan, because the plans generally cover dependents, and many make benefits available for those working only erratically in the industry or actually laid off, for whom claims may be high and no contributions are being made.

Under the "cap," a participant's additional taxable income would be a function of the amount by which the cost of his benefit coverage exceeded the "cap." Those with benefit coverage far in excess of the "cap" would pay much more than those who exceeded the "cap" only slightly. Thus, in addition to hitting those with "comprehensive" coverage, the "cap" would discriminate against those living in high-cost areas where the same basic coverage is more expensive, as well as older groups, groups with retiree coverage, groups in declining industries, those that provide extended coverage to unemployed workers and their families, and others.

On the other hand, the President's proposed tax "floor" of $25 per month for family coverage and $10 per month for individual coverage would likely affect all multiemployer plan participants. Thus, each participant with a family would have $300 in additional taxable income every year -- $120 per year for participants with individual coverage. The resulting individual tax liabilities would depend on the participant's tax bracket. However, for individuals earning $25,000 per year, we estimate that the average extra taxes per year would be more than $65 for family coverage and more than $40 for individual coverage, under the reduced tax rates proposed by the President.

As with the "cap," there are problems of relative equity in taxing everyone on the same flat dollar amount of their employer-paid coverage. For example, $300 in additional taxable income might be considered more onerous for a low-wage earner, and would represent a larger percentage of the total benefits provided to those with less comprehensive benefit packages.

Both the "cap" and the "floor" would be particularly burdensome for retirees, unemployed people, surviving spouses and dependents, and others with extended coverage under an employer-paid plan. These people might have little other income from which to pay the tax. Yet, it would hardly be fair to include the cost of retiree and other extended-coverage benefits in the costs on which active workers taxes are based.

The administrative burdens that would be imposed by a health care tax of any kind would be staggering. If withholding were required, it would likely have to be done by contributing employers. The plans themselves do not pay cash health benefits to participants from which they could withhold.

The contributing employers would not know enough about the participants' benefit eligibility and coverage to do withholding, and the paperwork necessary to give it to them would be overwhelming. Many employers know little more than the hourly rate at which they contribute to a multiemployer plan -- they wouldn't know which of the employees actually have plan coverage, or what their benefits are. Plans would have to send each of their hundreds or thousands of employers weekly printouts showing a current list of covered employees, whether such employees have individual or family coverage, and the value of that coverage. This is an extraordinary amount of paperwork in light of the large number of employers contributing to multiemployer plans and the generally small size of contributing employers.

Of course, no one would seriously propose taxing employees on contributions without regard to whether the employees are eligible for plan coverage. In many cases, employer contributions are measured by the hours worked by all bargaining unit employees, with a minimum amount of covered work required for an employee to gain and keep eligibility. Thus, someone for whom a contribution is made would not necessarily have health coverage that could be called "income."

Moreover, many plans don't know that particular employees have satisfied eligibility requirements until several months after eligibility is attained. Plans have to wait until they receive monthly or quarterly contribution reports from employers, and analyze the data. Indeed, in some industries, there are so many casual workers that plans ordinarily don't make a determination with respect to eligibility until a claim is actually made.

Most multiemployer plans of any significant size either have experience-rated insurance contracts or are self-insured. In both cases, the plans don't know what the cost of health coverage for a particular year is until substantially after the end of that year. Moreover, since most multiemployer plans are noncontributory, they don't ordinarily break down the cost between individual and family coverage. It would therefore be impossible for most multiemployer plans to provide up-to-date data on a weekly basis and withholding would not work.

An alternative to withholding would be to have employees compute and pay the tax at the end of the year. However, this raises serious questions of equity, especially for lower-paid workers who may find it extremely difficult, if not impossible, to come up with money sufficient to pay the tax all at once at the end of the year.

Finally, both the tax "cap" and the tax "floor" could easily prove to be the proverbial camel's nose under the tent. If a tax "floor" were enacted, it would be easy to increase the "floor" in future years until the entire amount of all employer-paid health care coverage were taxed. Similarly, a health care "cap" could be lowered in future years, and a larger percentage would be covered in any event unless the "cap" were raised each year to reflect increased coverage costs.

If Congress decides to tax health benefits, the basic revenue raising motives will be clear to all of the workers hit by the tax. They know, along with the rest of us, that it is neither "fair" nor a "reform" to tax their basic health care protection.

In short, we believe that taxing health care benefits would be unfair and largely unworkable under any type of proposal. These benefits serve crucial social purposes. Without them, there would be increased pressure for new and expanded government programs which would cost far more than the revenue collected through the taxation of private sector benefits. Thus, these essential benefits should continue to be encouraged, as they have in the past, through favorable tax treatment.

3. Nondiscrimination in Welfare and Pension Plans

The President's proposal would impose uniform nondiscrimination rules with respect to coverage, availability, and benefits on all employer-paid welfare benefit plans, including group term life insurance plans, health benefit plans, and qualified group legal services plans. In addition, the nondiscriminatory coverage rules would apply to retirement plans.

In general, these rules prohibit discrimination in favor of certain owners and highly paid employees (the "prohibited group"). However, the coverage of multiemployer plans is overwhelmingly rank and file, and there is no discrimination in favor of such employees. Moreover, the nondiscrimination tests proposed would be extremely unworkable for such plans. For these reasons, we suggest that alternative, more workable tests be prescribed for multiemployer plans. More specific rules also need to be developed to deal with the treatment of excludable groups and aggregation of multiemployer plans.

(a) Special Nondiscrimination Rules Should Be Provided for Multiemployer Plans

The proposed nondiscrimination rules would forbid discrimination in favor of employees: (1) owning one or more percent of a contributing employer; (2) earning more than $50,000 per year; (3) among the top ten percent of employees or the highest three employees by compensation and earning at least $20,000 per year; and (4) who are family members of another prohibited group member.

As noted above, multiemployer plans do not discriminate in favor of this prohibited group. The coverage of such plans is overwhelmingly bargaining unit employees (sometimes numbering in the hundreds of thousands) and not officers or owners of an employer. Such plans would, therefore, be happy to comply with nondiscrimination rules which are made administratively feasible.

Nevertheless, it would be virtually impossible for multiemployer plans to demonstrate that they satisfy the proposed nondiscrimination rules. These plans do not have the information necessary to identify prohibited group members. Thus, a few multiemployer plan participants may own a small percentage of a contributing employer. Union employees might participate in a contributing employer's stock ownership plan. However, multiemployer plans do not have any way of knowing which, if any, of their participants are prohibited group members on this basis.

Determination of whether an employee is among the top ten percent or the highest three employees by compensation (and earns at least $20,000 per year) would be even more complicated. In addition to having to determine the annual compensation of covered participants, the plan would have to determine the annual compensation of all other employees working for each of the hundreds or thousands of employers contributing to the plan. The plan's administrators would then have to compare the compensation of their covered participants with that of all other employees of the respective contributing employers. This chore would be made even more impossible by the fact that multiemployer plan participants often work for many different employers in any given month or week. Thus, the plans could not identify any one employer whose employees' compensation could serve as the basis for testing whether a particular employee is a prohibited group member on this basis.

Finally, multiemployer plans do not know which, if any, of their participants are related. Thus, even if they could identify some prohibited group members under the compensation and ownership tests, they could not determine which participants were prohibited group members by virtue of family relationships.

Since multiemployer plans in fact do not discriminate in favor of prohibited group members, it would be particularly inappropriate to subject them to a nondiscrimination test which would impose substantial administrative costs and burdens, and would be unworkable. We would be willing to explore with your staff alternative rules appropriate for assuring the continued broad-based character of multiemployer plans.

(b) Excludable groups

(i) Under the President's proposal, bargaining unit employees would be excluded in testing an employer's noncollectively bargained plans to see if they meet the nondiscriminatory coverage test. It should be made clear that the reverse is also true. Thus, in testing for nondiscriminatory coverage, multiemployer plan trustees should not have to be concerned about any other coverage their contributing employers may be providing for their noncollectively bargained employees.

(ii) Effect of Coverage of One or More Members of an Excludable Group

The President's proposal provides that, in testing for nondiscriminatory coverage, plans may disregard members of certain excludable groups, including employees covered by a collective bargaining agreement, so long as the particular plan does not benefit any employee in such class. In testing for nondiscriminatory coverage, this would seem to require a plan to consider all of an employer's collectively bargained employees if it covers even one such employee. We see no rationale for this result.

Some employers and unions may want to cover some but not all categories of bargaining unit employees in their company-wide plans. Further, in multiemployer cases, the parties could bargain in good faith to leave a special job category, such as apprentices, those under 21, or part-time workers, out of a plan, or provide a separate benefit package for them.

The President's proposal is also somewhat unclear with respect to how excludable group employees should be treated if they are included in plans. The proposal seems to indicate that excludable group individuals included in a plan must be given the same benefits as everyone else. However, it would make more sense to permit such employees to be included in plans at a lesser benefit level, if that is the result of good faith bargaining. This would enable employers and unions to provide some coverage for individuals for whom the alternative would be to provide nothing. In addition, as discussed above, the bargaining parties may decide in good faith to leave certain job categories out of a plan. These parties should have the alternative of including these workers at lower benefit levels. This would provide them with flexibility to provide appropriately for the special needs of various segments of the collective bargaining group.

(c) Aggregation with Other Employer Plans

For purposes of the nondiscriminatory availability and benefits tests, employer plans covering a common prohibited group participant would be required under the President's proposal to be aggregated, unless each of the plans could satisfy a more stringent nondiscriminatory coverage test. Employers could also elect to aggregate two or more plans.

It should be made clear that multiemployer plans would be tested on a plan-wide basis, and would not be required to be aggregated with each other or with single employer plans of their contributing employers.

Multiemployer plan trustees have no connection with, influence over, or knowledge of the existence, design or operation of any other plans of contributing employers. It would be unfair to test a multiemployer plan on the basis of actions taken by one or more contributing employers over whom the multiemployer plan trustees have no control.

On the other hand, when testing for discrimination in their single employer plans, employers should be permitted to take credit for the multiemployer coverage they provide for their employees. Otherwise, the nondiscrimination tests might unfairly limit employers who wish to provide pension and welfare coverage for their non-bargaining unit employees, some of whom may be prohibited group members. This would be unfair where there is in fact no discrimination because the employer is providing for non-prohibited group members under a multiemployer plan.

The Multiemployer Pension Plan Amendments Act of 1980, Pub. L. No. 96-364, recognizes that direct attribution of multiemployer plan benefits to a particular employer is not generally feasible in connection with the calculation of withdrawal liability. We expect that this will be true as well with respect to calculations necessary to test for discrimination. An easily administrable formula allocation will, therefore, be required to allocate each employer's share of multiemployer plan benefits, unless the multiemployer plan's trustees determine in a given case that it is feasible to make an attributable accounting thereof. For this purpose, we believe that each employer should be assigned a share of the multiemployer plan's benefits, based, in some fashion, on that employer's share of contributions.

In conclusion, we respectfully request: (1) that a special nondiscrimination test be provided for multiemployer plans, which would be appropriately fashioned to take account of the special nature and needs of such plans and the virtual impossibility that they could discriminate in favor of prohibited group members; (2) that plans covering primarily collective bargaining unit employees be permitted to disregard noncollective bargaining unit employees when testing for nondiscrimination; (3) that plans covering one or more members of a collective bargaining unit be permitted to exclude other such members or include them at reduced benefit levels; (4) that multiemployer plans be tested for discrimination on a plan-wide basis without being aggregated with any other plans; and (5) that contributing employers, in testing for nondiscrimination in their single employer plans, be permitted to aggregate the multiemployer coverage they provide for their employees with such single employer plans pursuant to a reasonable formula allocation.

4. Additional Tax on Early Retirement Benefits

The Treasury proposal would have imposed a 20 percent additional tax on the taxable portion of most distributions from tax-favored retirement plans before the recipient's death, disability, or attainment of age 59-1/2. This would have nullified, as a practical matter, the common multiemployer plan practice of providing early retirement benefits -- often at age 55. The President's proposal goes far towards alleviating our concerns in this regard by excluding most periodic payments at or after age 50 from the additional tax.

However, a number of multiemployer plans offer "service pensions" that allow participants to retire at any age with, e.g., 20 or 25 years of service. Service pensions are generally provided to employees who work in physically demanding jobs such as the trucking, maritime, and some construction industries. At age 45 or so, these employees may well be unable to find work at an adequate compensation and benefit level. Further, continuing to work at such physically demanding jobs after age 45 or so could be detrimental to these employees' health.

Accordingly, we suggest that service pensions with a minimum service requirement of, e.g., twenty years be excluded from the excise tax.

An additional exclusion should be considered for mandatory small benefit cash-outs of $3,500 or less made for the convenience of the plan rather than the participant. This would protect people with small benefits from inadvertently incurring the excise tax with respect to distributions they could not avoid taking.

Finally, under the President's proposal, distributions used to pay college expenses and to purchase first principal residences, and distributions used to replace certain unemployment benefits would be subject to a reduced ten percent tax. We suggest that the list of uses entitled to this special treatment be expanded to include uninsured casualty losses and medical expenses. These are uses which serve purposes of equal importance to the three uses for which special treatment is currently provided. Employees who find it necessary to request early distributions because of circumstances beyond their control, such as the loss of an uninsured home, car, or other important possession, or accident or injury are entitled to at least equal consideration with individuals wishing to purchase a first principal residence or pay their children's college expenses.

5. Changes in Internal Revenue Code Section 415 Defined Benefit Limits

Under current law, Internal Revenue Code ("Code") Section 415(b) forbids defined benefit plans from paying an annual benefit to a participant in excess of the lesser of: (1) $90,000 (indexed for inflation beginning in 1988); or (2) 100 percent of the individual's average compensation over his three highest years. However, plans are not treated as violating this limit if they provide an annual benefit of $10,000 or less to participants who: (1) have never participated in a defined contribution plan of the same employer; and (2) have at least ten years of service with the employer. If the individual has less than ten years of service with the employer, the $90,000, the 100 percent of compensation, and the $10,000 annual benefit limits are reduced on a prorated basis.

The President's proposal states that it would modify this phase-in over ten years of service by "providing for a phase-in of the $90,000 annual defined benefit dollar limit over the first ten years of plan participation." We believe it is important to make clear that the $10,000 de minimus annual benefit limit would continue to be phased in over years of service as is currently the law and would not be required to be phased in over years of actual plan participation. Otherwise, even long-time employees would not be entitled to this safe harbor, if they had not been covered long by the plan in question. We believe that long-term employees who will receive pensions of no more than $10,000 per year should be able to get that amount even if their employer doesn't join the plan until late in their careers.

Indeed, the President's proposal acknowledges that special rules will be needed to allow reasonable past service benefits for rank and file people. Multiemployer plans, the vast majority of the participants in which are rank and file employees, are an excellent example of the type of plan for which such special rules would be appropriate. Accordingly, we recommend that, at least for multiemployer plans, the defined benefit plan de minimis continue to be phased in over years of service, rather than over years of participation.

We also suggest that the $10,000 de minimis be indexed on the same basis as the $90,000 defined benefit plan limit. The value of a $10,000 benefit is shrinking just as fast as the value of a $90,000 benefit. Further, the effects of this shrinkage will be felt much more harshly by employees receiving only $10,000 per year than by employees receiving $90,000 per year. Thus, we believe it would be equitable to provide such employees with the same protection against inflation as is provided for higher paid workers.

6. Repeal of $5,000 Death Benefit Exclusion

For many years, collectively bargained employee welfare benefit plans have provided death benefits to participants and their beneficiaries through trusts exempt from taxation under Section 501(c)(9) of the Code. These trusts have historically been operated and financed in a manner comparable to group term life insurance arrangements. Death benefits paid from such trusts have been regarded as excludable under Code Section 101(a) from a recipient's income as amounts received under a life insurance contract. Ross v. Odom, 401 F.2d 464 (5th cir. 1968). Cf. Private Letter Ruling 7206209210A (June 20, 1972). This makes sense since, like life insurance contracts, these programs are formal, binding, and actuarially designed to provide the promised benefits.

Legislative history on the proposed repeal of the current $5,000 exclusion for employer-paid death benefits must ensure the continued availability of this exclusion. We suggest that the following language be included in both the Senate Finance Committee report and the Conference Committee Report:

> "The repeal of the $5,000 exclusion for employer-paid death benefits is not intended to restrict in any way the current exclusion as insurance proceeds available for death benefits paid from self-funded employer-paid welfare benefit plans. The Committee intends that death benefits paid to employees through a funded employee welfare benefit trust should continue to be regarded as paid pursuant to a 'life insurance contract' where the trust is operated and financed in a manner comparable to group term life insurance arrangements, under the principles of Ross v. Odom, 401 F.2d 464 (5th Cir. 1968)."

7. Modification of Loan Distribution Rules

The Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA") imposed new rules treating certain loans from retirement plans as taxable distributions. Under current law, however, loans that do not exceed specified amounts will not be treated as distributions if certain conditions are satisfied. The President's proposal would impose additional conditions for qualification for this special treatment.

The Conference Report on TEFRA clearly provides that:

> Investments (including investments in residential mortgages), which are made in the ordinary course of an investment program will not be considered as loans, if the amount of the mortgage loan does not exceed the fair market value of the property purchased with the loan proceeds. An investment program exists, for example, when trustees determine that a specific percentage or amount of plan assets will be invested in residential mortgages under specified conditions.

Any bill including loan distribution provisions should make clear that it is not intended to impose new restrictions on plan investment programs. In addition, any legislative history should emphasize that the statutory loan restrictions do not apply to adequately secured investments made in the ordinary course of an investment program, even if the plan participants are among the targeted market.

8. Legal Services Plans

Finally, I am particularly pleased to be able to express our strong support for the President's proposal to make permanent the present tax treatment of qualified group legal services plans which, through section 120, excludes from the gross income of an employee amounts contributed by an employer to a qualified plan, and the value of legal services received through the plan. As the leading congressional champion of legal services plans, you must be pleased, Mr. Chairman, at the growth and success of these plans over the last nine years. From fewer than 100,000 covered employees in 1976 when section 120 was enacted, legal services plans have grown to cover 13 million Americans, the largest number in employer-paid plans. I am pleased to say that multiemployer plans have been a significant factor in that growth.

Group legal services plans have proven their ability to delivery high quality legal services at low cost. They are especially effective at preventive legal care -- at avoiding or resolving problems without expensive litigation. Group legal services plans are supported by the labor and consumer movements, the legal profession and the insurance industry. There is no opposition to legal plans. Plans are in the best American tradition of pragmatic, voluntary group action to meet common needs.

Section 120 has proven its effectiveness in stimulating the growth of legal services plans at minimal cost in foregone revenue. According to the Joint Committee on Taxation, the 1985 revenue loss from section 120 will be just $32 million.

While better than 35% of the general population each year encounter problems that could be solved by a lawyer, only 10 percent actually seek legal assistance. By contrast, an average of 20 percent of the covered employees in a group plan seek legal services each year. These facts indicate that twice as many people obtain legal assistance in resolving everyday legal problems through participation in a group plan. Most of these employee-users receive preventive legal services that often make it possible to avoid litigation or serious or protracted remedial services. Thus, group legal plans tend to preserve employee morale and productivity and assist in unblocking our overburdened judicial system.

What is it about legal plans that creates "win-win" situations, where everybody benefits? Basically, it is that transaction costs are reduced when advance arrangements are made on a group basis for providing needed legal services. Advance payment is not as important as advance arrangements that make legal services readily available. These advance arrangements dramatically reduce the time, cost and uncertainty involved in selecting and consulting a lawyer when a legal question arises. Thus people covered by a plan contact a lawyer more often, but at an earlier point in the course of a problem. More people receive legal advice, about more matters, but matters are handled at lower cost and in a way that minimizes disputes and litigation.

Congress has an unbroken record of supporting legal services plans, from an amendment of the Taft-Hartley Act in 1973 to last year's extension of section 120. I am pleased that the Administration, too, now supports these inexpensive and cost-effective preventive law plans.

Thank you very much for the opportunity to make our views known.

The CHAIRMAN. Mr. Georgine, right at the end you mentioned group legal. Do your members have a fairly broad coverage in the different unions in group legal?

Mr. GEORGINE. It is beginning to get more broad now that it is becoming better known, and I would say if you used the word "fairly," I would say, yes; it is fairly broad.

The CHAIRMAN. What kind of services do the plans normally provide?

Mr. GEORGINE. The basic services, wills, divorce, and closing costs in housing, that kind of thing.

The CHAIRMAN. The kind of normal civil things that 80 to 90 percent of the public faces at one time or another.

Mr. GEORGINE. That they face very often in their lifetime, yes.

The CHAIRMAN. And the kind of services, by and large, with the cost of lawyers now, that your average member probably could not afford if they had to go out and pay the hourly fee that some lawyers charge or that many lawyers charge?

Mr. GEORGINE. You are absolutely right.

The CHAIRMAN. As we go through the bobbing and weaving on this bill, on the floor versus the cap on health insurance, you more than most are aware of how we got to the floor and the negotiations that went into it, and what was given up and what was accepted by the administration to get there. I won't bother to expand on that at the moment. Your views and mine, of course, correlate exactly. I don't like taxes on any of them, every benefit, is a benefit that the Government would otherwise be providing at an infinitely greater cost and with infinitely less responsiveness to your members and the public generally than what unions and employers or even nonunion employers are able to provide. We will see where that comes out as we continue going down the road.

Do you think it would be a good idea, because you and I have talked extensively about multiemployer plans, do you think it would be a good idea to deal separately with nondiscrimination and other rules that govern multiemployer plans, separate that out from tax reform?

Mr. GEORGINE. Yes, I think it would be. I don't think that tax reform really is the place to del with that issue.

The CHAIRMAN. With multiemployer plans you have a significantly different situation from a one-employer plan. You have a got people moving in and out, especially in the building trades, with different employers, working 4 months here and 6 months there, and to try to apply single-employer rules to multiemployer plans often becomnes impossible.

Mr. GEORGINE. We have been trying to tell the Congress that ever since ERISA was passed, Senator. It is quite different. The multiemployer universe is a great deal more complicated than the single-employer plans, and it is a special animal all by itself.

The CHAIRMAN. Senator Long?

Senator LONG. Mr. Georgine, the Lousiana Federation of Labor had a good president in Louisiana. His name is Victor Busey; I'm glad you know him—I see you smiling. He's a friend of both yours and mine. Many times, on labor issues where your union is interested, Mr. Busey has been the one who called me and asked me to vote ways that were important to you. So I guess he spared you the need of having to contact me either directly or through one of your group up here in Washington. I just want you to know that I'm around. [Laughter.]

You don't need to go through Mr. Busey, but it's perfectly all right with me if you do. [Laughter.]

Mr. **Georgine**. Senator, I have knocked on your door many times in the past and just like to save you the aggravation. [Laughter.]

Senator **Long**. Well, I want you to know we don't have any problems. And so far as I know, I don't find anything wrong with your statement, and I vote to support all of Mr. Packwood's ideas, provided it is mutual. [Laughter.]

I am willing to work with you on the matters you testified about here today. Thank you.

Mr. **Georgine**. Thank you very much, Senator.

The **Chairman**. Senator Durenberger.

Senator **Durenberger**. Mr. Georgine, on the issue of multiemployer pension plans, it is in that area that at least in my State we are seeing the most creative use of flexible benefits. Is that generally true around the country? A lot of the unions have moved through the multiemployer pension into flex-benefit of one kind or another, and at least in my State find it a very successful way of buying a variety of fringe benefits. Is that true around the country?

Mr. **Georgine**. Not necessarily, Senator. I think flexibility is nice. I think, you know, that it depends greatly on the basic coverage. You know, if the basic coverage is there on a nondiscriminatory basis to everybody, and they are well covered, then you would start thinking about flexibility.

Senator **Durenberger**. Do you have a position that would advocate more section 125 flexible benefits as long as the base is maintained or increased, so it isn't a matter of having to trade off benefits in order to get choice? What is your view on that?

Mr. **Georgine**. I think you have just said it right there. If there is basic coverage on the essentials that are needed, on a nondiscriminatory basis for everyone in the collective bargaining unit, and then there is room for flexibility to pick and choose, there is nothing wrong with that, and we are all for it.

Senator **Durenberger**. All right.

I read your statement only once, and I was looking for more of a plug for 125, only because of the experience we have had in Minnesota with the small unions, particularly in the construction trade. I would appreciate some elaboration maybe in writing on your views generally, because I think all of here, or some of us anyway, are strong supporters.

Mr. **Georgine**. I would be glad to do that, Senator.

As it stands right now, in multiemployer funds the cafeteria concept has not been used much at all. So we don't have a great deal of experience with it. We do have views on it, and I would certainly like to reduce them to writing.

Senator **Durenberger**. Then an exchange for all the societal value that you ascribe to the tax exemption. Are there a couple of things you can think of that we ought to be getting out of our plans. And I would just concentrate on the health plans? One, for example, is continuity. That is, in a period of unemployment. Some of the unions are able to negotiate that one fairly well out of an employer, but some others are not able to. In a lot of the employment sector, we found when unemployment was quite high, folks were dropping off the end for some period of time—6 months, 9 months, 1 year they had nothing, absolutely nothing. And it has struck me that it would make some sense for this great society of ours, then, to demand in exchange for the tax benefits for the health plan that there be some continuity out there, possibly a year, to be built into the plan. Maybe it doesn't have to be financed by the employer, but the employee ought to have the right to buy at the same group rate, or something comparable to that rate.

Do you have a position, or would you favor generally our legislating some continuity into these plans?

Mr. GEORGINE. Well, whether you do it by legislation or how you do it, I think you have to look at it. First of all, in a multiemployer plan or at least in the collectively bargained plans that we are most familiar with, we try to develop what is a fair and decent basic coverage for what we can negotiate, really. I mean, you know you only can buy as much as you have the money to pay for, really. And then we have over the years, because of the cyclical nature of industry in general and particularly because of construction, tried to establish a level that will give you extended coverage. For instance, the maximum number of hours anyone can work in a year is 2,000 hours, give or take a few. So most of our plans—most of our plans—have coverage, complete coverage, after 1,000 hours, some even after fewer than 1,000 hours, and they may have partial coverage. And that partial coverage would extend for the remainder of that year.

Senator DURENBERGER. But you negotiate that now on an individual basis?

Mr. GEORGINE. We negotiate that now.

Senator DURENBERGER. Let me ask you a question. How about catastrophic? Don't you think that this something we should try to legislate in exchange for this tax subsidy? Should we require there be sort of a minimum kind of catastrophic plan in all of these health plans that are offered?

Mr. GEORGINE. I think whether you should legislate for it or not, again, we have it in most of our plans. we have catastrophic insurance in most of our health plans.

Senator DURENBERGER. What is your view on whether or not we should extend the same kind of tax subsidy or tax credit to people who don't work for somebody else or don't get their health care from somebody else—self-employed, for example? Shouldn't they be able to get a tax credit against their tax liability the same say that employed people do?

Mr. GEORGINE. I don't have any objection to that, as long as it is offered on a nondiscriminatory basis.

Senator DURENBERGER. Thank you.

The CHAIRMAN. Senator Heinz.

Senator HEINZ. Bob, going back to my question, I guess, to Carl Sardegna, is it your feeling that we have looked too much at at ho to keep the rich from getting too rich, as opposed to ensuring that people who need coverage actually get coverage, as a general rule here? Our focus legislatively has lacked real commitment to making sure that people who are going to need adequate retirement benefits, and probably are going to be pretty hard pressed trying to get by on just Social Security, ought to have a better chance of vesting and being covered and having pension adequacy.

Mr. GEORGINE. Well, I think that is true. I mean that is what we really have to look at, is those who need the opportunity and the chance, do not have it, could not live on Social Security benefits, and we should see that they get adequate coverage when that time comes, yes.

Senator HEINZ. Now, like many people, I suppose, I find the pension area a fairly complex area, and there are a lot of wrinkles in it. You are representative of multiemployer large plans here. And as I try and think through alternatives to dealing with this, one of the things we want to be sure is that we don't do something that is going to mess up the kinds of plans you have. But you stated, I think, that it would be virtually impossible for multiemployer plans to demonstrate compliance with the nondiscrimination rules in the administration proposal. Yes?

Mr. GEORGINE. Yes, that's right.

Senator HEINZ. If, instead of worrying about the prohibited group, which is the basis for the administration's new proposal, we simply said that if you cover anyone you have to cover everyone who earns less than X, and let's say X is the Social Security wage base, the maximum Social Security wage base, and everybody in a particular plant or busniess has to be covered, would that be an easier test to meet?

Mr. GEORGINE. It certainly would be an easier test to make sure.

Senator HEINZ. Would there be any problem with it as far as you are concerned?

Mr. GEORGINE. I don't have any problems with that, no. So long as collective bargained plans need include only covered workers.

Senator DURENBERGER. All right. Thank you.

Thank you, Mr. Chairman.

The CHAIRMAN. Any other questions?

Senator DURENBERGER. No, thank you, Mr. Chairman.

Mr. GEORGINE. Thank you, Mr. Chairman, and Senators, it is a pleasure to be here.

The CHAIRMAN. Thank you.

Now we will have a panel of Dallas Salisbury, Bill Bailey, Dr. Alain Enthoven, and Dr. John Bomba.

I am going to let just a few people clear out of the room in back and then take you in the order that you are on the witness list.

[Pause.]

The CHAIRMAN. All right, Mr. Salisbury, why don't you go ahead?

STATEMENT OF DALLAS SALISBURY, PRESIDENT, EMPLOYEE BENEFIT RESEARCH INSTITUTE, WASHINGTON, DC

Mr. SALISBURY. Mr. Chairman, it is a pleasure to be here today. Since the entire statement will be in the record, I will try to be brief and just hit a few key points.

The CHAIRMAN. Let me indicate to all of the witnesses, your statements will be in the record in total, and if you will limit yourselves to 5 minutes so that we can ask questions, we would appreciate it.

Mr. SALISBURY. Mr. Chairman, one point that is not frequently made about the President's proposal is that it does maintain the current tax treatment of 72 percent of all employee expenditures; that is, the 72 percent of benefits that are fully taxable.

The CHAIRMAN. That counts Social Secutiry, doesn't it?

Mr. SALISBURY. That counts Social Security and other benefits, yes.

In terms of other benefits, there is a reduction in Federal income tax as a result of employer's spending approximately 5 percent of wages and salaries on tax-exempt health insurance, life insurance, and approximately 4 percent of wages and salaries on tax-deferred retirement and capital accumulation programs.

The President's tax reform proposal does in fact, contrary to some news media emphasis, contain some very fundamental changes. The first panel focused on those.

First, it takes a policy that has been in place since 1921, a two-track policy if you will, that said there would be tax incentives for retirement pension programs on the one hand and separate tax incentives for mainly defined contribution savings programs, and very much says in its proposals, "We choose to really do away heavily with the second, and make all of the incentives focus on retirement income and pensions." It's not necessarily a bad idea, subject to policymakers' decisionmaking, but a very, very significant change proposal.

Second, as you well know, new limits are proposed on contributions to pension and capital accumulation programs that would be far lower than current program limits. And, because of that, from research that has been done, there is an indication that lower income people, in terms of voluntary participation in these programs, might have fewer opportunities to participate and participate less.

Third, as the last panel and much of the questions dealt with, new nondiscrimination standards are offered. I think there is consistent agreement across all those involved in this area that nondiscrimination is desirable. But from the research we have been able to do thus far, it does very much confirm the statements of prior witnesses that a significant number of plans would not be able to pass the nondiscrimination criteria tes, including some employment settings where 100 percent of all employees are offered coverage. And that gets to the point that Senator Heinz was raising, the so-called controlled group situations—the breakdown in the flexible benefits area of up to 50 or 60 cells—where you may be doing it very honorably in terms of nondiscrimination, but you would still be deemed to not be meeting the tests the President has proposed. I don't think that is his intent. It is our view that people are not looking to say, "Don't provide nondiscrimination critera," but our work indicates that very significant additional technical work is needed before the nondiscrimination proposals would be workable.

Also, health insurance for the very first time would be taxed under the President's proposal when provided in the employment setting. Again, a very fundamental change in national policy. The additional $10 to $25 floor proposed is not likely, from our research, to reduce coverage if kept at that level; but if it were to be raised in the future, our research indicates that it could. In fact, an analysis published in 1984 by economist Deborah Chollet indicated, in line with the question Senator Durenberger asked, that if health insurance were to be fully taxed, as many as 10 million individuals would give up coverage in the first year alone, and additional coverage losses could be expected in the future.

I have stressed, the President is not providing full taxation, but I think it is important to note that very significant losses of coverage could occur, were that full taxation ever to be contemplated.

Senator **Durenberger**. And neither is Durenberger. That is Bradley-Gephart.

Mr. **Salisbury**. I just said you raised the issue. Yes, sir. Bradley-Gephart did. That is true.

The President may be correct in his assessment that longstanding employee benefits policy needs to be changed, but there is not evidence in the tax reform package that long-term consequences of the proposals have been evaluated. This is most particularly true, for example, with the nondiscrimination test, which came forth for the very first time with the President's proposal and were not contained in the Treasury One proposals, so they could not have been evaluated sooner.

In terms of talking about contradictions, as an earlier witness noted, there are inherent contradictions in the proposal: reducing access to capital accumulation funds while expanding individual retirement accounts, propopsing nondiscrimination tests that would cause some plans that cover all workers to be disqualified, taxing health insurance for 67 percent of taxpayers because the others don't have it rather than providing a deduction to those who do have it.

In short, the President's proposal has far-reaching implications that should be carefully considered.

Thank you, Mr. Chairman.

The **Chairman**. Thank you.

Mr. Bailey?

[Mr. Salisbury's written testimony follows:]

EBRI

T-46

Statement On

The Impact of the President's Tax Reform Proposal on Employee Benefits

Before The

United States Senate Committee on Finance

July 19, 1985

of

Dallas L. Salisbury*
President
Employee Benefit Research Institute

*The views expressed in this statement are those of Dallas Salisbury and should not be attributed to the Employee Benefit Research Institute, its officers, trustees, sponsors, or other staff.

Dallas Salisbury is President of the Employee Benefit Research Institute, a nonprofit, nonpartisan, public policy research organization. Before joining EBRI he served in senior career policy research positions at the U.S. Department of Labor and the U.S. Pension Benefit Guaranty Corporation. This statement draws heavily from research studies conducted, published, and copyrighted by EBRI.

07/16/85

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Statement

Mr. Chairman, it is a pleasure to appear before the Committee today to discuss the impact of the President's tax reform proposals on employee benefits. The Employee Benefit Research Institute has undertaken analysis which comprehensively assesses the interrelationship of the tax code and the provision of employee benefits. The Institute is a nonprofit, nonpartisan research organization based in Washington, DC. EBRI does not make recommendations for or against legislation the Congress may be considering, but we do work to make available pertinent facts that may bear on your decisions.

Employee benefits are effective and efficient providers of economic security. In an April 1985 survey conducted by Hamilton and Staff, employee benefits were found to be widespread. 82 percent reported being covered by company health insurance, 69 percent by company life insurance, and 50 percent by company pensions. For full time workers coverage is even more widespread, according to Census Bureau surveys. The world of employee benefits is made up of four primary components.

- Mandatory programs including Social Security, Medicare, workers compensation, and unemployment compensation represent the first component. These programs provide the basic level of protection demanded by society on a nearly universal basis. Over 25 million retirees now receive benefits from these programs. Social Security provides higher proportional benefits to low and moderate income individuals, and for higher income retirees, 50 percent of their benefit is taxed. A portion of unemployment benefits are taxed. The Reagan package would tax all unemployment and workers' compensation benefits. On average USA employers spend 9.5 percent of wages and salaries on these programs; 29 percent of all employee benefit spending.

- Voluntary tax-exempt programs, including health insurance, life insurance up to $50,000. educational assistance above $5,000, dental insurance and vision insurance, represent the second component. Ninety-six percent of all full-time workers in medium and large firms have health insurance; 96 percent have life insurance. The Reagan package would tax the first $10 of an individual health premium and $25 of a family premium paid by the employer. On average USA employers spend 5 percent of wages and salaries on these programs.
- Voluntary tax-deferred programs including retirement, capital accumulation, and long-term disability plans represent the third component. Eighty-two percent of all full-time workers in medium and large firms have retirement or capital accumulation plans and 50 percent have disability protection. Nearly half of all recent retirees receive retirement income from these programs. Payments out of these plans are treated as taxable income to the degree that contributions were not. The Reagan package would change nondiscrimination rules and establish excise taxes for some benefit payments. It would establish an $8,000 limit for 401(k) plans and change distribution rules. On average USA employers spend 4 percent of wages and salaries on these programs.
- Voluntary tax-exempt fringe benefit programs including parking, cafeterias, merchandise and travel discounts, are frequently viewed as the fourth component. Spending on these programs is less than 1 percent of wages and salaries, and frequently they exist for the convenience of the employer. Discussion of these programs should not

be allowed to color basic employee benefits which provide economic security.

- o Voluntary taxable programs including vacation time, sick time, and other time not worked, are too often included when talking about employee benefits. The average USA employer spends almost 14 percent of wages and salaries on these programs, or nearly 43 percent of what are reported as "employee benefit" expenditures.

Media reports and government discussion generally lump all these different types of employee benefit program expenditures together and assume that it is all tax exempt. NOTE: 72 percent is either mandatory or fully taxable; just over 12 percent is taxed upon benefit payment; while just under 16 percent is tax exempt.

This may seem a minor point, but the debate over the taxation of employee benefits takes on a much different caste when the perception is that 32 percent of wages and salaries escape taxation as a result of voluntary employer and employee action -- even if the fact is that only 5 percent escapes total taxation. As you well know, perception has the effect of reality when it comes to influencing decisions.

Let us take a moment to look at employee benefit programs against some of the perceptions that have driven legislative debates in recent years, and also come up at times in the current debate over tax reform and the tax treatment of employee benefits.

Why Do We Have Employee Benefits?

There is general agreement on why employers and unions established employee benefit programs and why the government chose to encourage them with tax incentives.

- protection against loss of income due to illness, disability, unemployment, or retirement;
- productivity gain due to employee psychological well being;
- enhancement of the ability to manage work force size and to allow timely retirements; and
- to obtain group purchase advantages.

The Employee Retirement Income Security Act of 1974 gave recognition of multiple needs by providing clear incentives to encourage savings both for retirement and for separation from employment at earlier ages.

The government has generally:

- agreed that it was appropriate national policy to provide incentives to have workers protected against loss of income;
- wanted to encourage private dollars to supplement Social Security for retirees;
- liked not having to enact National Health Insurance because employer provided health insurance had become almost universal; and
- generally felt that employers and unions were acting responsibly.

Effects of Taxing Employee Benefits

The Reagan Administration tells us that the rationale for what they have proposed is to achieve fairness, growth, and simplicity. What they have proposed may in fact be appropriate for public policy; that is for the Congress to determine. The Reagan proposal for employee benefits taxation is not the fairest alternative; may be adverse to capital formation, and therefore, for economic growth; and would add to the complexity of employee benefit plan administration rather than simplifying it. As a result, one cannot help but ask: what is the rationale for the employee benefit changes as compared to the rationale for the full package?

Why Change The Tax Treatment of Benefits?

A reading of the Reagan package, backed up by conversations with government staff, indicates as least four rationales for the changes. Each represents a desire to change long-term national policy.

What is Retirement Income?

Since 1921 the Congress has attempted to encourage savings and capital accumulation "until separation from employment" in addition to retirement income that might be paid out as a stream of payments beginning at retirement. This dual track policy was readily evidenced by the tax treatment given lump-sum distributions upon separation of employment or after age 59 and 1/2. The Reagan proposal seeks to narrow national policy to encourage the use of a stream of payments rather than lump-sum distributions. While lump-sum distributions are still allowed, the Reagan package reverses the current incentives. Its proposed changes would provide tremendous incentives to roll over the dollars into another retirement account and to withdraw the dollars over one's entire expected retired life. The proposal, in short, represents a fundamental policy change.

How Much is Enough?

Between 1921 and 1974 the Congress provided incentives for savings and capital accumulation without a concept of particular limits. Economic growth had been assumed to be benefited by capital formation. Therefore, the objective was, for practical purposes, to encourage as much as possible.

Congress introduced limits in 1974 on the amount of defined benefit that could be funded for and the maximum annual addition to a defined contribution account, but did not place a limit on the maximum ultimate payout. They provided in this way an incentive to seek high rates of return and to save at the maximum possible level. With TEFRA in 1982, the Congress took another step and introduced a lower combined plan limit on what could be set aside for any individual. The Reagan proposal asks Congress to go one step further: to limit the maximum annual benefit one can receive by introducing an excise tax on "excess" amounts. And, the proposal strikes at those who would hoard the savings for their heirs by asking the Congress to require retirees to draw funds out of plans at a minimum rate. In short, the Administration proposal says that there is an amount of money which represents too much tax-favored retirement income and that it is intended that plans only provide retirement or penalty taxes will be imposed.

Shouldn't Everyone Get The Same Thing?

Over the years the Congress has introduced nondiscrimination and coverage requirements intended to assure that the benefits of tax incentives go to more than the highest paid. The Administration proposal moves further in that direction by expanding the group that must be included in all plans and by narrowing or eliminating contribution and benefit differentials.

Should Anything Escape All Taxation?

From 1921 until 1981 the Congress expanded the tax incentives for employee benefits frequently. 1982 marked a distinct change in that direction as they began to tighten and to narrow. This was the year in which the maximum defined benefit that could be funded for and the maximum defined contribution addition, and the combined limits, were all reduced and frozen The employee benefits legislation of 1984 continued that trend, as do most of the proposals to date for "tax reform." The proposal for a health floor (or the health tax cap of the November Treasury proposal), if adopted, would bring us to the point where no widespread employee benefit was tax free.

Who Receives Employee Benefits?

The provision of employee benefits follows a pattern: basic benefits are provided first. The normal sequence: health, life, retirement, savings, and on from there. For an employer the single biggest determinants of when employee benefits will be provided are profitability, unionization, and work force size. The availability of benefits falls across the entire earnings spectrum, but is heaviest for full time workers. Eighty-three percent of all nonagricultural wage and salary workers in 1983 earned less than $25,000.

Retirement and Capital Accumulation

Over 800,000 employer sponsored plans are now in operation in the private sector. Thirty-seven percent are defined benefit plans, with more than 40 million active participants. Sixty-three percent are defined contribution plans, with over 27 million active participants. As many as 80 percent of the participants in defined-contribution plans also participate in a defined-benefit plan.

Of all civilian workers, the Census Bureau found that 52 percent are covered by these plans. Of those meeting ERISA participation standards, 70 percent are covered by these plans. Eighty-two percent of all full-time workers in firms with 250 or more employees are covered by a plan. And 76 percent of those covered and 70 percent of those vested earned less than $25,000 in 1983.

What about actual benefit receipt? The Social Security Administration reported recently that among new retirees in 1981 56 percent of married couples and 42 percent of unmarried retirees had income from an employer-sponsored pension -- more than double the rate of 1961. In 1983 over 10 million workers reported to the Census Bureau that they had been in a plan in previous employment and 6.6 million either took a lump-sum distribution or were entitled to an eventual annuity.

Employee Salary Reduction Programs

The Revenue Act of 1978 provided for these new programs under section 401(k) of the Internal Revenue Code. The November Treasury proposal would have ended them. As you have heard, the new proposal would modify them. As of 1983 nearly 5 million employees were eligible for these programs and 1.2 million actually participated. A recent survey placed the number of eligibles in 1985 at 20 million.

Health Insurance

Health insurance is the most widespread employee benefit. 60 percent of all civilian workers have primary health insurance coverage and another 20 percent have secondary coverage. The addition of dependents and retirees more than doubles this number. Sixty-nine percent of all tax returns filed in 1983 would have been affected by a tax on health insurance.

Other

Other voluntary tax exempt programs include life insurance up to $50,000, educational assistance, dental insurance, vision insurance, group legal, and dependent care. Ninety-six percent of all full-time workers in medium and large firms have life insurance; 71 percent have dental insurance; and 27 percent have vision care.

Who Would be Affected by Benefit Tax Change?

The numbers just presented provide an indication of the total number of workers and families that will in some way be affected by changes in the tax treatment of employee benefits. Precise effects are difficult to pinpoint, however, because individuals have different career patterns and different packages. But a general framework can be set out. For over 800,000 unions and employers, an effect would be a reduction in flexibility to structure the total compensation package to meet the needs of a changing work force.

Defined Benefit Plans

As many as 20 percent of defined benefit plans allow for lump-sum distributions instead of annuities. The numbers are small, but growing. And all defined-benefit plans can make distributions when the total dollar value is less than $3,500. The Reagan proposals would make this design approach very unattractive.

Defined-benefit plan annuity tax treatment remains constant under the proposal. Wage and salary growth would make the new maximum benefit rule apply to large numbers at which time significant design change will need to be contemplated. The proposed nondiscrimination tests that treat all units of a controlled group of companies as one employer would cause many large companies to have plans lose their tax-favored status, even in situations where all workers are covered. The goal is a worthy one, but significant technical work is needed beyond the May proposal.

Defined-Contribution Employer Contribution Plans

These plans -- money purchase and profit sharing primarily with their 27 million participants -- would be dramatically changed in the terms of the distributions and the taxation of distributed amounts.

These changes would require the plans to be rethought and would require a new tax planning and retirement planning approach for individuals. The "phase out" of ten year forward averaging will make this redesign a long term process. For participants it will make them look at these plans as a place to park money for retirement quite clearly, or until the next job, rather than saving for special needs or emergencies. Based upon documented experience this means that employees will voluntarily set aside much less in these plans.

Employee Salary Reduction Programs

These plans and their approximately 8 million active participants would be affected by distribution changes and discrimination test changes. Maximum contributions capped at 8,000 with an IRA offset could affect 5 percent of participants in year one, with that number growing each year.

Employers are still likely to offer these programs, but they are likely to play a much smaller role than some had contemplated. Due to the proposed restrictive rules on access to funds, employees are likely to use these plans less.

Health Insurance

Approximately 63 million workers would have new income to declare were initial health insurance premium dollars taxed. The equity in the proposal is hard to find. It makes no difference what the level of coverage is that you have or what percent of the total premium the taxable amount represents.

The floor at $10 and $25 is unlikely to cause a drop in provision. The main question? What if it rises? EBRI research indicates that as more and more of the insurance is taxable, more and more workers won't want it. Adverse selection will be most intense among younger workers. As a result, the cost of insurance for all others will increase as the group declines in size. Over time, this could have dire consequences. This, at a time when the Congress is concerned about those without health insurance.

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Cafeteria Plans and Reimbursement Accounts

We estimate that approximately 5 million workers now have these plans available to them. Most would be affected by the Reagan proposal, either having to drastically change their reimbursement accounts or eliminate them.

Full choice plans will continue to be attractive to those primarily seeking to please employees and meet changing work force needs. Those seeking to use the arrangements for health cost management could still do it with a reimbursement account funded by employer dollars at the same level for all employees. But for many employers that have established premium payment only reimbursement accounts or accounts for other purposes with very low participation rates, plan continuation will be troublesome.

New Nondiscrimination Standards

As noted above, the new standards could cause many workers to lose certain types of coverage while other coverage would have to expand to meet the rules. They would make some plans like 401(k) less attractive to employers. They would add significantly to the complexity of plan administration, and complexity itself creates loopholes. The objectives are laudable, but technical work is needed.

Fringe Benefits

Reagan proposes to apply nondiscrimination standards to these benefits. Since the Deficit Reduction Act of 1984 said many of these benefits were difficult to value, applying nondiscrimination standards to them would be difficult. To the extent that these benefits create a nuisance for employers, they could be dropped.

Would Benefit Plans Still be Offered?

The general answer must be "yes" in the initial years. But, out year consequences as wages and prices change could be significant.

Conclusion

The government began building a legal structure for employee benefits in 1921. The goal: to protect workers and their dependents against loss of income; to provide economic security. The result: near universal protection for employees of medium and large businesses; growing protection for employees of small businesses; and a very significant reduction in the demands placed upon the government for direct expenditures that would far exceed the revenue cost of the incentives.

STATEMENT BY BILL BAILEY, PRESIDENT, AETNA LIFE & CASUALTY, HARTFORD, CT, ON BEHALF OF THE HEALTH INSURANCE ASSOCIATION OF AMERICA

Mr. BAILEY. Thank you, Mr. Chairman.

My name is William Bailey. I am president of Aetna Life & Casualty and this year's chairman of the Health Insurance Association of America. I appear here on behalf of HIAA to discuss the issue of taxing employee benefits, particularly the administration's recommendation for imposing a tax on health insurance.

I am delighted to have the opportunity to appear before this committee and particularly you, Mr. Chairman, who has long recognized the importance of employee benefits to American workers.

We are not here today to quarrel with the concept of tax reform. The health insurance business supports the view that our tax system should be equitable and simple, and we commend the dedicated efforts of your committee to review the many implications of the proposed tax reform.

We are here, however, to urge that your committee and the Congress not view its goals too narrowly and without regard for the important social policy purposes that have been built into our present tax system. we regard this broader social policy frame of reference as particularly pertinent to the evaluation of proposals to tax employee benefits.

We firmly support continuation of the present system of tax preferences for employee benefits, including health insurance. All of us need an incentive to protect ourselves adequately against intangible financial risk; otherwise, faced with the high current cost for an uncertain future benefit, most people will find that they cannot afford adequate protection and will take the chance that "it won't happen to me." The tax preferences have provided the necessary incentives for both employers and employees.

With these tax incentives, the vast majority of employees receive benefits that protect them and their families against fundamental financial risk. Close to 90 percent of full-time workers have employer-provided health insurance, over 90 percent have life insurance, over 74 percent participate in pension plans. Without tax incentives, employers and employees would have had little inducement to utilize benefits as a form of compensation.

Despite the country's longstanding policy of tax incentives to encourage employee benefits, despite its success in providing protection to so many, and despite the high level of public support for current policy, the administration has decided that employees should pay a tax on their health insurance benefits. The administration has supported the tax on health insurance benefits since 1981. Its original proposal called for a tax cap of $70 monthly for single employees and $175 for families. Employer contributions to health insurance coverages in excess of these amounts would be fully taxable to the employee.

The HIAA, as you know, has long opposed a tax cap on health benefits. A wide range of other organizations, including labor, consumer, and employer groups have joined in this opposition. The reasons for opposition are well known but sufficiently important to me to summarize them here briefly:

The tax cap is unfair because it in no way recognizes that health care costs vary depending on the location, occupation, age, and health risk of employees.

The cap would result in decreased levels of coverage as young and healthy workers opt of the plan.

The administration of the cap would add more complexity, not simplicity, to the tax law.

The cap would have no measurable effect on health care cost control.

Congress has never seen fit to adopt the tax cap, and we think for a good reason.

The administration's latest proposal is a health insurance tax floor. It would assess federal taxes on every participant in the health plan by imputing income of $10 or $25 per month for family coverage. The per-month floor for single coverage avoids some of the worst inequities and problems posed by the cap, but it too has serious negative implications.

First, we are puzzled by the administration's rationale for recommending the floor. It says the tax is necessary because the current exclusion for health insurance benefits constributes substantially to horizontal inequity and to higher than necessary marginal rates. We find this a surprising statement in light of the administration's overall tax reform recommendations.

Under our current system, no other major tax preference is as socially valuable or as progressive as the exclusion of employer contributions to health benefit plans. It benefits 162 million individuals, far more than homeowners' mortgage interest deduction, the capital gains exclusion, or the deduction for charitable contributions, all of which the administration proposes to retain. Yet, in the name of horizontal equity, the tax reform proposals have singled out health benefit plans as a source of new revenue.

Second, the floor begs the basic issue if fairness. All those covered by employer health plans would be liable for the same tax, regardless of how different their benefits were.

Third, we are concerned with the precedent the floor would establish. If it were passed, it would be the first income tax imposed on basic employee benefits.

The concept could easily be extended to require employees and employers to include the imputed amount for Social Security tax purposes. The floor could be raised as new revenues were necessary. Both of these possibilities could lead to a tax that hits hardest on low and moderate income employees. Also, it wouldn't be long before the floor is pointed to as a convincing precedent for taxing other benefits, such as life insurance and pensions.

To many, we suspect the administration's proposed tax seems like a small price to pay if it helps to achieve tax reform.

The CHAIRMAN. I will have to ask you to conclude, Mr. Bailey.

Mr. BAILEY. I will, Mr. Chairman.

We wonder whether such a tax truly helps accomplish real reform.

One of the principle purposes of tax reform, as we understand it, is to make our tax system fairer by eliminating preferences that benefit only a few, thereby permitting lower tax rates for all. Health insurance, however, is unlike most other preferences because its benefits are enjoyed by so many. Most of the very people who would benefit from lower tax rates due to the broadened base would pay for the lower rates by the inclusion of an essentially equal amount of additional taxable income from the health tax. We do not view this result as accomplishing meaningful tax reform.

In conclusion, we urge your committee to reject any proposal to tax workers' health insurance benefits.

Thank you very much.

The CHAIRMAN. Thank you.

Dr. Enthoven, welcome back to the committee.

[Mr. Bailey's written testimony and a letter to Senator Packwood from William O. Bailey follows:]

STATEMENT

of the

HEALTH INSURANCE ASSOCIATION OF AMERICA

on

TAXATION OF EMPLOYEE BENEFITS

Presented by

William O. Bailey
Chairman, Health Insurance Association of America
President, Aetna Life & Casualty

Before the

Committee on Finance
United States Senate

July 19, 1985

I am William O. Bailey, President, Aetna Life and Casualty, and Chairman of the Health Insurance Association of America, on whose behalf I appear today. This statement is also supported by the American Council of Life Insurance, the National Association of Health Underwriters, and the National Association of Life Underwriters.

The HIAA has approximately 340 member companies who write over 85% of the health insurance sold in the United States by insurance companies. The ACLI has 615 member life insurance companies who write about 95% of the life insurance written in the United States and hold 97% of the assets of insured pension plans. Many of its members also write health insurance.

The principal purpose of this statement is to comment on the proposals to tax employee benefits, particularly those included in the Administration's tax reform plan.

INTRODUCTION

Employee benefits have a long history in the United States as part of our national commitment to providing a base of economic security through a private system for active workers, displaced and disabled workers, retirees and their dependents and survivors. These benefits consist principally of group health, disability and life insurance and retirement plans.

Without a doubt, these benefits meet important financial and social needs of American workers, including many lower and moderate income individuals who could not otherwise afford to purchase individual insurance coverages or save for retirement. Equally important, because the benefits are provided through a private system, government has not needed to develop additional public programs to serve these needs.

Congress has long recognized the important role played by employee benefits. A key element in its efforts to provide support for these benefits has been the use of tax laws to generate incentives for American business to create and maintain programs which benefit workers' security.

Congress has provided for tax-free treatment of group health insurance for over 30 years. Pensions and group life insurance were given favorable tax treatment virtually since the income tax laws were adopted.

We firmly support continuation of the present tax incentives. People need an incentive to protect themselves adequately against intangible financial risks. Otherwise, many people will choose not to purchase necessary protection for affordability reasons or on the shortsighted theory that "it won't happen to me." This is why the current tax-preferred treatment for benefit plans has been so critically important. With tax incentives, as statistics demonstrate, millions of employees and their families are protected against fundamental financial risks. Without such incentives, many employers and employees would never have added benefits as a form of compensation.

We are now facing reconsideration by the Administration and by Congress of the cost/benefit relationship of our system of tax incentives for employee benefits. Many of the supporters of taxing employee benefits assert that the costs are too high, that the taxable wage base for income and Social Security tax purposes has eroded and that tax rates are higher than they need be.

It is a misperception that employee benefits, including health insurance, are eroding greatly the taxable wage base and causing higher tax rates. Employee benefits do make up some 32% of wages and salaries but only a small portion of this constitutes tax-free benefits. Some 14% are fully taxable benefits such as vacation pay; 9% are government-mandated benefits, e.g., Social Security. About 5% are retirement benefits, on which workers ultimately pay taxes. The remainder, only about 4 1/2% of wages and salaries, are tax free and are principally composed of group health, life and disability insurance.

Also, employee benefits are not growing at a fast pace. The primary growth in employee benefits occurred between 1950 to 1980. During this period, many employers developed benefit plans, and improved existing ones. Costs also increased. Since 1980, however, coverage expansion and benefit growth has slowed greatly. We expect little future growth in group health and life insurance coverage because over 90% of full-time workers already participate. Health care inflation has slowed significantly.

We should not, then, decide to tax employee benefits because they threaten to seriously erode the taxable wage base. Moreover, no analysis of the "costs" of our system of tax incentives would be complete without full consideration of the enormous social needs served by our employee benefits system and the likely consequences if the incentives are altered. As a result of the current incentives that some would like to abandon, millions of families have acquired the necessary protection against medical care costs and loss of income due to untimely death and retirement. A 1983 survey done by the Chamber of Commerce of the United States revealed that 99% of the firms surveyed offered group health and life insurance, 83% offered a pension. A 1983 U.S. Department of Labor survey found that 96% of all workers in medium and large sized firms were covered by group life insurance. A similar percentage were covered under group health insurance plans, while 82% of the workers in these firms were covered by a pension plan.

Many of these benefits go directly to low and moderate income families who could not otherwise afford to purchase individual insurance coverages or save for retirement. Seventy-five percent of employees covered by employer-sponsored life, health and pension plans earn less than $25,000 per year. Seventy-four percent of the employer monies placed in pension funds are targeted for individuals with incomes less than $50,000. Pension and group life and health insurance coverages are widely distributed among all income groups.

Not that long ago, Henry Steele Commager summed up the social attitudes of the day as: "Have faith. Should illness befall you, some kind person will provide." Today, thanks to Congress' support and encouragement of private sector employee benefit programs, private employers have built an effective and efficient arrangement covering the needs of employees through employer-sponsored pension and welfare plans. As the coverage statistics demonstrate, the programs benefit the majority of workers and their dependents. Working people no longer need to depend on a "kind person" or on government to meet critical financial needs. In fact, most American workers have come to take the presence of employee benefits and their current tax treatment for granted, viewing them as representative of a social contract.

As the Committee evaluates proposals to tax employee benefits, we encourage you to consider the proposals in the broadest possible context. Our current system of tax incentives has resulted in employer-provided benefits that are unequaled in the world. To remove these incentives by imposing a tax on employees carries with it the risk that this system will dismantle, over time, and that government will find itself in the position of providing benefits previously provided through employers.

ADMINISTRATION PROPOSALS TO TAX EMPLOYEE BENEFITS

The Treasury Department's initial tax reform recommendations called for taxation of many employee benefits, including full taxation of group life insurance, a "cap" on the tax-free treatment accorded group health insurance and elimination of section 401(k) plans.

The Administration's employee benefit tax proposals are an improvement over the Treasury proposal in that its plan calls for continuation of the current tax treatment of employer contributions to group life insurance. However, it also recommends that taxes be imposed on group health insurance and that contributions to Section 401(k) plans be limited. We are opposed to these recommendations, believing they are counterproductive to long established Congressional policy supporting employer programs that help ensure worker and family security. Our specific objections to these and other provisions are outlined below.

PROPOSED TAXATION OF EMPLOYEE HEALTH CARE BENEFITS

The Administration proposes that employees with employer-provided health insurance pay a tax on $10 a month for employee-only coverage and $25 a month for family coverage. For the first time, some 65 million workers would be paying a tax on health care.

Health care is considered to be a vital necessity by the American public. Providing access to health care, through adequate health insurance benefits, is an important and long-standing social goal of our nation. The existence of Medicare, Medicaid and an extensive system of employer provided health coverage demonstrates just how strong a desire the public has for health care. The widespread availability of private health insurance benefits has accomplished three things: (1) it has removed a significant source of economic uncertainty for families (ensuring greater worker productivity and overall well-being); (2) it has contributed directly to the improved health status of the American people; and (3) it has eliminated the need for the government to provide health care financing through increased taxation.

We estimate that at the end of 1982, approximately 162 million persons under age 65, including spouses and children, were covered by one or more forms of private group health protection. That represents 80% of the under 65 civilian population and is a five-fold increase since the end of World War II.

In addition to the number of workers covered by employer-provided group health insurance, there are significant advantages gained from the group insurance system for distributing employer-sponsored benefits. Intense competition in the group insurance and plan administration business, economies of scale and the relatively sophisticated buying power of employers and organized employee groups result in employee group coverage that costs less than coverage available in the individual market. Even more important, underwriting health and life insurance on a group basis makes benefits available to employees and dependents who, because of their age or health status, might find it difficult or impossible to find individually underwritten coverage.

The group mechanism has also played a vital role in expanding the types of coverages available to employees to include major medical protection, dental and vision care. Employers and insurers have also been in the forefront of efforts to control health care costs through plan design. Many health plans now include cost-saving features such as home health care, preadmission testing, second opinion surgery, ambulatory surgery coverage and preventive care coverage. In the last few years, we have been witnessing a tremendous surge in HMO and preferred provider program development -- both of which are considered effective cost containment devices. Much of this growth has been brought about by employers and insurers.

While we have made great strides in providing group health insurance, there are still some gaps in coverage. Although health insurance (except for dental care) is almost universally available across income levels, its comprehensiveness still varies widely among employers. There are also individuals who do not have access to employer-provided coverages and who perhaps cannot afford individual coverages.

Universal private health coverage for all employees and their dependents remains a worthy national social goal. The present tax treatment of employer-provided group health insurance has contributed significantly to a sound health care system for American workers through a remarkably effective partnership composed of the government, employers and employees. Cutting back on these tax incentives, even to the extent the Administration has proposed, would postpone, possibly permanently, the realization of universal coverage. The benefits and the tax treatment of them are considered so important that 79% of the public polled in a recent Roper survey felt it was unacceptable to tax part of health insurance benefits as a way of realizing lower tax rates. A June 1985 nationwide Washington Post - ABC News public opinion poll also found that, by 80 to 17 per cent, those surveyed oppose a tax on part of workers' benefits, such as health insurance.

Despite the high level of public support for current tax policy, the continuing need to make improvements in access to health care, and the country's long-standing tax policy of encouraging employee benefits, the Administration has decided that taxing health insurance is a good idea.

To some, the Administration's proposed tax may seem like a small price to pay if it helps achieve tax reform. We wonder whether such a tax truly helps accomplish overall reform. One of the principle purposes of tax reform, as we understand it, is to make our tax system fairer by eliminating preferences that benefit only a few, thereby permitting lower tax rates for all. Health insurance, however, is unlike most other preferences because its benefits are enjoyed by so many. Most of the very people who would benefit from lower tax rates due to the broadened base would pay for the lower rates by the inclusion of an essentially equal amount of additional taxable income from the health tax. We do not view this result as helping to accomplish meaningful tax reform.

Specific Objections to the "Floor"

We note at the outset that the floor concept avoids some of the worst inequities and problems posed by the cap. The floor is administratively simpler (at least at the initially proposed levels). It would be less burdensome and more equitable than the cap to the aged, the sick, those in higher risk occupations and workers in regions of the country where health care is most expensive. Further, the floor would not selectively discourage coverage for important preventive health services while a cap would. In effect, structuring the tax as a floor eliminates some of the serious inequities posed by the cap, but it has its own set of problems and these are discussed below:

There is virtually no logic, in terms of either social or tax policy, to support a tax on employer-sponsored health benefits; its only objective is to raise revenue. The Administration proposes the tax because it claims "the exclusion contributes substantially to horizontal inequity and to higher than necessary marginal tax rates." We find this a surprising statement in light of its overall tax reform recommendations.

Under our current system, none of the major tax preferences are as socially valuable or as progressive as the exclusion of employer contributions to health benefits plans. Only about 13 % of the benefit is conferred on those with incomes above $50,000 - compared to 30% of the benefit of the homeowner's mortgage interest deduction, 64% of the capital gains exclusion and 55% of the deduction for charitable contributions, all of which are retained in the Administration's plan. Yet, in the name of horizontal equity, the tax reform proposals have singled out health benefit plans as a source of new revenue - even though the benefits under these plans are more equitable, horizontally, than any of the major tax preferences.

Moreover, horizontal equity has never been the sole consideration in establishing tax policy. The current treatment and any change to it must also be evaluated in light of its social implications. To tax health insurance benefits would be changing a preference that helps to provide 162 million individuals with access to quality health care. The significance of any change to the current preference should not be underestimated in a selective quest for horizontal equity.

We do not quarrel with those who express concern for individuals who do not have access to employer-provided health insurance. But we see no reason to curtail a preference that benefits so many in deference to a minority (about 13 million) who purchase individual insurance. The better way to correct any inequity between individuals with employer coverage and individuals who must purchase individual coverage is to allow such individuals to deduct part or all of their health insurance premiums. Until recently, the tax law permitted such a deduction, but it was repealed in 1982. We suggest a reassessment of the merits of this deduction, rather than the imposition of a new tax on workers.

The floor is inequitable. All those covered by health plans would be liable for the same tax, regardless of how different their benefits were. For example, an employee with a contributory basic hospital benefit, for which the employer's contribution could be as little as $750, would pay the same tax as an employee covered by a non-contributory major medical plan with employer contributions in excess of $3,000.

Because the bulk of health benefits go to lower and middle-income workers, any tax on these benefits will hit hardest on lower and middle-income families. This problem will be accentuated under the floor concept if the imputed income is also applied to the social security tax base. Although the Administration's recommendation is not entirely clear, there are some suggestions that the additional $120/$300 annual income would also be included for social security tax purposes. If so, the result would be a substantially non-progressive tax. As the table below illustrates, nearly one-third of the total tax revenues raised by the floor would come from the payroll tax:

	1986	1987	1988	1989	1990
Income Tax Revenues ($ Bil.)	2.4	3.5	3.7	3.8	4.0
Social Security Tax Revenues	1.1	1.6	1.7	1.7	1.9

(Social Security Estimates Prepared by the ACLI and Include Taxes Paid by Employer and Employee)

Among lower- and middle-income families, this increase in social security taxes would significantly reduce the benefits they are expected to derive from other Administration tax reform proposals.

It is a bad precedent. The tax on health benefits under the Administration proposal also lends itself readily to substantial increases in tax revenue by merely raising the maximum amount includable as imputed income. The prospect would be that, with the precedent in place, health benefits would become a natural source for new tax revenues. To those who say the floor would stay at $10/$25, we point to the recent experience where Section 415 limits on deductions for pension contributions were reduced, and indexing postponed by The Deficit Reduction Act of 1984.

Taxation could signal the beginning of the end for employer-provided health care plans and an irreversible shifting of the cost of providing health care to the government. Not only is this unnecessary, it would be expensive. The Joint Committee on Taxation's own figures on "outlay equivalents" (the amount of federal outlay needed in order to produce directly the equivalent of the benefits from the "tax expenditure") show that it would cost the government billions of dollars more in direct outlays to provide workers with the current level of employer-provided health benefits than is currently foregone as tax receipts.

We urge the Committee to reject the Administration's proposed floor.

A Health Insurance Tax "Cap"

Although the Administration's plan has altered the original Treasury proposal from a health tax cap to the floor, there are already indications from Treasury Secretary Baker that the Administration remains interested in the cap. Taxing employer provided health insurance is fundamentally unsound, whether the tax is in the form of a floor or a cap.

The HIAA along with a wide range of other organizations, including labor, consumer and employer groups, has long opposed a tax cap on health benefits. The reasons for opposition are well-known and can be summarized as follows:

Job, Age and Location Discrimination

- The burden of the tax cap would fall unequally on workers depending upon where they work, their ages and their occupations. Taxing group health insurance in the way proposed by Treasury will discriminate against workers in high health care cost areas - California and New York for example - where the cost of health care coverage can be three to four times the cost of the same coverage in other areas of the country. Second, the tax would also be heaviest on groups composed primarily of older workers whose health care costs are more than those for younger workers. In addition, the tax would discriminate against workers employed in high-risk or hazardous occupations since higher health premiums must be paid to cover the risks.

Adverse Selection by Individuals

- Imposing a tax on group health benefits could result in adverse selection as the young and healthy opt out of the plan, leaving older and less healthy members in the group to incur greater overall costs. The resulting degeneration of plans would move the burden of providing health care to the Government.

Reduced Preventive Care

- The tax cap would place essential preventive care in jeopardy as employers who want to avoid additional reporting requirements and employees who do not want additional taxable income will move towards limiting contributions to the amount which is not taxed.

Added Complexity

- The tax cap complicates, not simplifies, the tax law. The complexity arises from the processes and difficulties involved in computing per employee costs around the country, reporting costs to employees, including the cost in the employee's tax return and auditing all of the above. Treasury's statistics show that taxing employees on employer contributions above the cap would mean an increase in the taxable income of approximately 50% of civilian employees who receive some employer-provided group health insurance. More employees would be affected as time passes.

Double Taxation

- Government programs have failed to cover adequately the health care costs of low income people in our society. For example, only about half of the poor and non-poor are covered by Medicaid. The result has been that hospitals and physicians provide large volumes of uncompensated care. The costs of this care is imposed, like a tax, on private health benefit plans, helping to drive premiums above the level of a tax cap. In other words, the tax cap represents a form of double taxation.

Not Health Cost Containment

- Taxing employees on their group health insurance is not the way to reduce "overconsumption" of health care. Hospital costs are the major factor in medical care inflation. These costs are now being addressed directly through cost control programs, preadmission testing, second opinions before surgery and emphasis on review of capital programs. Hospital admissions are down slightly, average length of stay is down substantially, and hospital price inflation is down below 10 per cent. The problem of inflation in health care costs should be addressed and is being addressed through changes in the way the health care system works, not through an additional tax on workers.

We have raised a number of objections to two specific proposals to tax health insurance. Our fundamental point, however, should not be obscured by our comments on these two proposed taxes. We are opposed to any taxation of health insurance. It simply does not make sense to remove key incentives to encouraging employer-provided health insurance coverage. The need for medical care is a fact of life. It is not a "fringe" benefit. If the vast majority of Americans do not gain access to it through employer-funded insurance, the responsibility most assuredly will fall on the government. This would be unnecessary and unwise, and we urge your Committee to reject the proposal to tax health insurance.

PROPOSED NEW UNIFORM NON-DISCRIMINATION RULES FOR EMPLOYEE BENEFIT PLANS

Under the Administration's proposal, statutory non-discrimination rules would apply, for the first time, to insured health plans and the specifics of existing rules for all plans would be substantially changed.

We are not opposed to extending non-discriminatory requirements to insured health plans, provided that such requirements are workable and consistent with sound public policy objectives. We are concerned, however, that the specific recommendations developed by the Administration are not workable. Many health and pension plans would fail the new tests, especially plans sponsored by large firms with divisions engaged in a variety of businesses. The new rules would reduce the flexibility of employers to design benefit programs to meet the needs of different employee groups. We believe rules in this area can most appropriately be developed outside of the context of this tax reform proposal. If, however, this Committee does intend to address this issue, we are willing to work with your Committee and staff to more fully analyze the proposals and to develop alternatives, if necessary.

PROPOSED PENSION AND RETIREMENT SAVINGS TAX PROVISIONS

We have had a long-standing national commitment to providing incentives for private pensions and capital accumulation plans. Together with Social Security and individual savings, private pensions play a vital role in ensuring that employees have adequate retirement income. As a nation, the United States has one of the lowest savings rates, and without incentives, individuals would not start to save for retirement until it was too late.

The private pension system plays another key role in our national economy that should not be overlooked. It provides considerable long-term funds for capital formation. At the end of 1983, total assets of private pension plans and state and local retirement plans ammounted to nearly $1 trillion. These plans are providing a growing part of monies supplied to U.S. credit and capital markets. In 1983, some $101 billion, or 19% of the total funds raised for such markets, came from these plans.

In light of the important multiple roles that pension plans play, we are pleased that the Administration proposes to leave intact the basic tax-deferred system for qualified plans. The pension provisions of the Administration's plan would, however, make a number of complicated changes in the tax treatment of pension distributions, contributions, benefit limits, and non-discrimination rules. The ostensible purpose of these changes is to establish simple and uniform rules to assure that the broadest possible segment of the work force participates in pension and profit-sharing plans, accumulating reasonable savings for distribution at retirement only. While these are generally worthy goals, the Administration's proposals would produce neither simplicity nor uniformity, and are likely to reduce participation - especially among lower- and middle-income people in retirement savings plans. More importantly, these changes concern national retirement policy and should be considered in that context.

401(k) Plans

The insurance industry welcomes the Administration's decision to set aside the original Treasury proposal to repeal Section 401(k). However, its proposed modification of this Section would greatly reduce participation in these plans, despite the ample documentation that 401(k) plans are much more attrative to lower- and middle-income employees than are IRAs. Moreover, unlike any of the changes envisioned for qualified retirement plans under the

Administration proposal, 401(k) plans would be subject to an unreasonable $8,000 contribution limit. The following are the most severe problems generated by the Administration's proposals:

Restrictions on Withdrawals

- By effectively prohibiting withdrawals of employee elective contributions prior to an employee's separation from service, the Administration would be imposing on 401(k) plans rules that are more restrictive than those applying to all other retirement plans, including IRAs. In practical terms, 401(k) plans would be treated like defined benefit plans. The result would be considerably lower participation by younger and lower-paid employees who fear that financial hardship would require their getting at their funds.

Actual Deferral Percentage

- The new "actual deferral percentage" (ADP) test is considerably more restrictive than the current one-third/two-thirds test. It would create numerous problems. The overwhelming majority of existing, non-abusive 401(k) plans would fail to meet the test, even in the absence of the new withdrawal restrictions. However, because of the reduced participation engendered by those restrictions in lower-paid employees, satisfying the new ADP test would be made doubly difficult. Also, the new ADP test would be very difficult to administer. It would require careful ongoing monitoring of many individuals' contributions, generating confusion and unproductive administrative expenses.

Tie to IRAs

- After having imposed on 401(k) plans the distribution restrictions most suitable to defined benefit plans, and a unique and severe non-discrimination test, the Administration then imposes an unindexed IRA integrated $8,000 contribution limit. This tie-in to IRAs is a complete about face from the defined benefit approach and seems to state that 401(k) plans are most similar to IRAs. The Administration should make up its mind. It can't have it both ways. Clearly, the desire for uniformity, consistency and administrative simplicity would lead to the conclusion that the general Section 415 limits on contributions to pension and profit-sharing plans were reasonable and appropriate for 401(k)s and that an additional cap is unnecessary.

Distributions from Retirement Plans

The Administration also proposes a 20% excise tax on the taxable portions of early withdrawals from all other retirement plans (reduced to 10% if used for home purchase, college expense or while unemployed). As a preliminary matter, it is inconsistent to have a hardship provision and then apply a 10% penalty tax on distributions made pursuant to that provision. Moreover, though the intention is to "recapture" the value of the tax benefit for pension contributions not held until retirement, in fact, the excise tax is a harsh penalty. It more than recaptures the benefits of tax-deferred savings, unless the assets are left in the plan for many years. For example, using reasonable assumptions, we find that the 20% excise tax would result in a penalty such that a participant in the 35% tax bracket would have been better off saving on an after-tax basis if the plan assets had to be withdrawn prior to nearly twenty years of participation. For lower-bracket employees, the time to "break-even" would be even longer. Rationally, these employees, for whom retirement saving is most important, would have little incentive to participate in pension plans. Clearly the various problems inherent in a flat excise tax should be studied before any action is taken to extend that concept or increase the tax.

Elimination of Ten-Year Forward Averaging

The elimination of ten-year forward averaging, proposed by the Administration, is a substantial increase in the tax on lump-sum withdrawals and, until its impact has been assessed, further reductions in the incentives to participate in pension plans would be unjustified.

We have a general concern that many of the Administration proposals related to retirement plans are peripheral to the issue of tax reform. They have a negligible financial impact and are actually manifestations of Treasury's views on the restructuring of our national retirement system. Tax reform proposals and legislation are not the appropriate forums in which to carry on the debate over national retirement policy. Discussions are underway on this subject as part of a special study commissioned by this Committee and also with the staffs of the Labor Committees. We believe that all retirement plan provisions in the Administration proposal should be removed from the tax reform legislation and debated in that context.

OTHER ADMINISTRATION PROPOSALS TO TAX LIFE AND HEALTH INSURANCE COMPANIES AND POLICYHOLDERS

In addition to the employee benefit proposals, there are other provisions in the Administration's plan that also are of great concern to us, including proposed taxes on individual life insurance and annuity policyholders and changes in the taxation of life insurance reserves and life companies. There also would be new treatment of reserve deductions for health and disability insurance through the application of the Administration's qualified reserve account proposal. These proposals will be addressed in greater detail by the American Council of Life Insurance in other hearings before your committee.

CONCLUSION

The health and life insurance business supports the concept that our tax system should be equitable and simple. This goal, however, should not be perceived narrowly and without regard for the important social policy objectives that previous Congresses established for our tax system. Concern for social policy objectives is particularly pertinent to the evaluation of employee benefit tax proposals.

We recognize the Congress' task in developing a tax reform bill is not an easy one. But we are firmly convinced that taxing employee benefits is not in the best interest of workers, their families and the country. Our current system of encouraging employer-provided coverages has worked remarkably well. Coverage is widespread; it is provided through an efficient, effective, flexible group mechanism; and it has relieved government of the responsibility.

The specific proposals advanced by the Administration are inconsistent with our country's long-established policy favoring employee benefits, and we urge your Committee to reject them. To impose any tax on employee benefits would establish a bad precedent and could signal to employers and employees that the proposed taxes are only the first step.

We urge Congress to continue the present system of tax incentives so that our employee benefit programs remain intact.

Ætna

William O Bailey
PRESIDENT

August 14, 1985

The Honorable Bob Packwood
United States Senate
259 Russell Senate Office Building
Washington, D.C. 20510

Dear Senator Packwood:

On July 19, I appeared before the Senate Finance Committee to testify on behalf of the Health Insurance Association of America and Ætna Life & Casualty on the tax reform proposals affecting employee benefits. There were two issues raised at the hearing that warrant additional comment on my part. The first concerns a Congressional Budget Office Study of the value of the "tax subsidy" for employer-provided health care benefits to workers at different earnings levels. The second relates to the importance of tax incentives in ensuring widespread medical care coverage. These are discussed separately below. I would like to request that you consider including these comments in the hearing record.

Tax Subsidy by Income

There were several questions from Committee members concerning a 1982 CBO study that estimated the average annual tax benefit by income group of the exclusion for employer-provided health insurance. Specifically, the CBO study reported that the estimated benefit of the exclusion in 1983 for households with incomes between $10,000 and $15,000 per year was $83. This compares to a CBO estimated benefit for households with annual incomes of between $50,000 and $100,000 of $622. These figures suggested that higher income individuals benefit far more from the health benefit exclusion than lower income ones. As I indicated in response to the questions, I was unfamiliar with the study. I reviewed it subsequent to the testimony and do not agree with the study's implication that higher income individuals benefit more from the exclusion. To the contrary, the exclusion is more valuable to low and moderate income individuals than high income ones.

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First, the figures relate far more to our progressive tax system and do not tell us very much about the real value of the health benefits actually received by any income group. As indicated in my testimony, the overwhelming majority of employer-provided health benefits go to low and moderate income workers. Eighty percent of workers receiving employer-sponsored health coverage earned less than $25,000 in 1982. Furthermore, within any one firm's health benefit plan, the employer's contribution does not vary by income. For example, in the Ætna employees' plan, our cost for individual coverage is $600 per employee; for family coverage, $1,800 per employee - for all employees regardless of salary. These benefits represent 5 to 14 percent of wages for the $10,000 to $15,000 wage earner, but only about 1 to 2 percent of wages for the $50,000 to $100,000 wage earner. In other words, the real dollar value of employer-provided health benefits, whether individual or family coverage, is a higher percentage of income for the lower paid than the higher paid worker.

It is, however, inevitable that under our progressive tax system, income exclusions will appear to be worth more to higher than lower income individuals. If Congress were to reduce marginal tax rates (as under the tax reform proposals), the apparent difference in tax benefit for the higher paid vs lower paid groups would be greatly reduced. Moreover, as I indicated in my testimony, it makes no sense for Congress to attack the health benefit exclusion while leaving intact, as the Administration has proposed, the far less progressive benefits associated with the deductions for homeowner's mortgage interest and the charitable contributions and the capital gains exclusion.

Second, there is a problem with looking only at the direct benefits of a tax preference to measure its value to any individual. The true benefit of a tax preference is the direct benefit less the individual's share of the higher taxes paid to support the tax preference. And here our progressive tax system acts as a two-edged sword: while the direct benefits of tax preferences increase with income, there are also higher taxes on income to support the preferences.

Specifically, in 1982 those in the $10,000 to $15,000 income bracket paid in aggregate 6.9% of all individual federal income taxes, compared to 15.8% for those in the $50,000 to $100,000 income bracket. It is reasonable to assume that these two groups shared the cost of supporting the health benefits tax preference in the same proportion. In 1982, the estimated cost to the Treasury of this exclusion was about $13.6 billion. (This also represents the amount that was needed to be raised by higher taxes on other income.) By inference, we assume those in the $10,000 to $15,000 bracket paid $938 billion (6.9% of 13.6 billion), or an average of $65 per taxpayer in this bracket. On the other hand, those in the $50,000 to $100,000 bracket paid $2.1 billion (15.8% of 13.6 billion), or an average of $861 per taxpayer in this bracket.

Therefore, the net benefit of the health exclusion to taxpayers in each of these two income groups is:

Income Bracket Benefit	Direct Benefit of Health Exclusion (CBO)	Higher Taxes to Support Health Exclusion (Ætna)	Net
$10-15,000	$ 83	$ 65	$ 18
$50-100,000	$622	$861	-$239

In other words, lower income people on average are financially better off with the tax exclusion than they would have been without it. Conversely, higher income people on average are made substantially worse off by the incorporation in our tax code of a health benefits exclusion, since most of the burden of paying for the higher taxes on other income required to offset the exclusion falls on them.

Incentive Effects

One other issue raised at the hearing that deserves further comment concerns the consequences for health insurance coverage levels if the current tax exclusion were limited or removed.

Benefits would then become a form of taxable compensation, similar to wages. Under this approach, employees are likely to demand and employers to offer, a choice between wages and non-cash compensation in the form of health care benefits. Dallas Salisbury cited Employee Benefits Research Institute simulation results suggesting that full taxation of employer contributions to health insurance might lower the total rate of private health insurance coverage among workers and their families by more than nine percentage points, or over 10 million people.

I agree with statements made by Mr. Salisbury and affirmed by Dr. Alain Enthoven that if given a choice between wages and taxable benefits, young or healthier and lower paid employees would more often than not choose cash compensation, not health care benefits. Ætna's underwriting experience with small employer plans, where employee contributions are typically higher than in large employer plans, supports this conclusion. When it has been necessary to raise the employee's portion of the premium for the plan, participation by younger and healthier employees invariably drops. Over time, this leads to problems of adverse selection, raising the cost for all those who remain in the plan. The cycle is then repeated. A blend of sound tax and social policy should avoid this result.

I would be happy to discuss any of these issues with you or your staff further. Please do not hesitate to contact me if we can be of help to you in your deliberations.

Sincerely,

W O Bailey

W. O. Bailey

cc: Members of the Committee on Finance
Dr. Alain Enthoven
James Moorefield
Dallas Salisbury

STATEMENT BY DR. ALAIN G. ENTHOVEN, PROFESSOR OF PUBLIC AND PRIVATE MANAGEMENT, GRADUATE SCHOOL OF BUSINESS, STANFORD UNIVERSITY, STANFORD, CA

Dr. ENTHOVEN. Thank you, Mr. Chairman.

The favorable tax treatment of certain fringe benefits can serve important social purposes: Tax-deferred retirement plans encourage saving for an economically self-sufficient retirement, and exclusion of employer contribution from taxable income has encouraged the spread of health insurance. So, while acknowledging the great appeal of the flat tax idea, it is important to bear in mind the social purposes of these provisions.

But the present tax break for employer-provided health insurance has four major things wrong with it, and the President's tax reform proposal does little or nothing to correct some of them while making others worse.

What is needed is a cap on tax-free employer contributions coupled with extending the same tax subsidy to health insurance to everyone, whether or not they have an employer contribution. This would be similar to what Congress has done for retirement plans. Better still, if tax subsidies to health insurance are a good idea, we ought to make a refundable tax credit or direct subsidy to health insurance available to everyone.

The present tax break for health insurance will cost the budget about $49 billion next year. It wouldn't be surprising if flexible spending accounts for medical expenses cost another 411 billion. The potential loss is much greater. And the revenue loss to the Federal budget has been growing at a rate that doubles its share of the gross national product in a decade.

A tax on the first $10 or $25 of employer-paid health insurance is not the way to correct this; it is regressive, and it does nothing to bring the growth of this item into line with the growth of the gross national product.

The distribution of the benefits of the present tax break is inequitable. About three-quarters of tax-free of employer contributions go to households with incomes above the median. The present tax subsidies do little or nothing for those who need them the most, the part-time employed, the intermittently and self-employed, the unemployed, and those in marginal industries without fringe benefits, the widows and divorcees who lost their health insurance when they lost their husbands, and, generally, people who don't have employer-provided plans, who exist by the tens of millions. Yet, these are the people that tax subsidies to health insurance should be targeted on.

If you believe that the budget can stand $60 billion of tax subsidies to health insurance and flexible spending accounts, then that amount ought to be divided up among all people and not targeted on upper income employees.

Senator Heinz put his finger on it exactly, "We are helping those who need it least, and not helping those who need it most." And the President's proposal makes this inequity worse.

The incentive in the present tax break encourage upper income people to buy ever more generous cost-unconscious health insurance, thus contributing to medical inflation. The present tax break is responsible for the paradox that millions are over-insured, thus contributing to inflation, while millions of others are uninsured because they are getting no help through the tax system. Through the tax code, the Government subsidizes the actions of upper income people to bid up the prices and standards of care that the uninsured must pay for directly, and the Government must pay in Medicare and Medicaid.

We need a tax cap at least to make insured people cost conscious. And the President's proposal does nothing to reform incentives.

Finally, the present tax break reinforces the link between jobs and health insurance. Why should the benefits of this subsidy be limited to those who have employer contributions? We should use the Tax Code as a lever to help and encourage everyone to insure and to stay insured. The President's proposal does nothing to help this situation.

By capping the tax break and extending the same deduction to everyone, Senator Durenberger's Health, Equity, and Fairness Act of 1985 addresses all of these problems in a rational and equitable way. Enactment of that bill would be a large step in the right direction toward tax subsidies and help for everyone in the maintenance and acquisition of their health insurance.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Doctor.

Dr. Bomba.

[Dr. Enthoven's written testimony and of follow up letter from Dr. Alain G. Enthoven follows:]

Draft for Review
15 July 1985

Memorandum for Senator Dave Durenberger

From: Alain Enthoven

Subject: Estimated Revenue Loss to the Federal Budget From Favorable Tax Treatment of Employer-Paid Health Benefits

Estimates of the volume of private health insurance have recently been revised upward by about 18 percent by the Health Care Financing Administration.. In May 1984, the IRS clarified the tax treatment of "cafeteria plans" under Section 125 of the IRC. Employers and employees may tax shelter the employee's health insurance premium contribution and out-of-pocket medical expenses by the use of "salary reduction" and "forfeitable flexible spending accounts." Employers and employees have powerful incentives to take advantage of this opportunity, and use of this tax break is apparently spreading very rapidly. I estimate that if employers of 90 percent of employees take full advantage of this to shelter premiums, the revenue loss to the Federal budget at 1986 spending levels will be about $49 billion.

Estimating the revenue loss from the use of flexible spending accounts (FSAs) is much more speculative. But the potential losses are very large. At 1986 spending levels, patient direct out-of-pocket personal health care expenses for those under 65, not counting nursing homes, will be about $72 billion. If only families with above average incomes took advantage of salary reduction and FSAs and were only 80 percent effective in sheltering their expenses, the revenue loss would exceed $11 billion.

Thus, the potential revenue losses from present provisions for favorable tax treatment of employer-paid health benefits exceed $60 billion at 1986 spending levels.

I cannot predict with any assurance how long it will take employers and employees to get organized to take advantage of these provisions. Perhaps it will take until 1987 or 1988 for most of them to do so. But the procedures are not complicated. And I do not believe that the argument that it will take them another year or so to exploit this tax break fully diminishes the public policy significance of this finding.

The Appendix to this memorandum explains and documents the basis for these findings.

Draft for Review
15 July 1985

Appendix

Federal Tax Revenue Losses Resulting From Favorable Tax Treatment of Employer-Paid Health Benefits

The purpose of this memorandum is to provide approximate estimates of the amount of tax revenue the federal government will lose in 1986 because of the present favorable tax treatment of employer-paid health benefits. These estimates must be approximate because of data imperfections, the need to use averages and approximations, and the hazards of extrapolating beyond actual experience. Nevertheless, the amounts of money involved are so great that a correction of plus or minus 10 percent would have no impact on the public policy conclusions following from this analysis. Suggestions for ways of improving the accuracy will be gratefully received by the author.

The aggregate volume of private health insurance in 1983 has been estimated by the Health Care Financing Administration at $110.5 billion. (1) The study increased the previously estimated volume for 1982 by 18 percent. The amount of this that is associated with employment groups, and is potentially tax sheltered through employment is not known with precision. Some "group policies" are sold to individuals who belong to associations that are not employers. On the other hand, some "individual policies" cover people in professional corporations or other small businesses and their premiums can be tax sheltered. As an approximation, I assume these two effects offset each other and that the percent of revenue in group policies equals the percent that is potentially tax sheltered. Arnett and Trapnell (1) estimate that 6.5 percent of insurance company benefit payments are associated with individual policies. I assume that the same percent applies to Blue Cross-Blue Shield, and half that to prepaid plans.

This produces an estimate of 5.8 percent of private insurance benefit payments associated with individuals, not employment.

A similar estimate can be obtained from the National Health Care Expenditures Study. (2) Of 153.3 million privately insured under 65 year olds in 1977, 17.6 million were covered under either nongroup policies or group policies not employment-related. On the other hand, the mean annual premium for policies not employment related was only two-thirds the premium for employment-related coverages. Assuming that no non-group insurance can be tax sheltered, this would imply that 7.8 percent of the premium revenue cannot be sheltered through employment. However, some individual policies can be sheltered, so I will split the difference and use 6.8 percent.

What will this amount be in 1986? For many years health spending and insurance have grown faster than the GNP. For example, from 1978 to 1983, health expenditures grew from 8.8 to 10.8 percent of GNP. The share of personal health care expenditures paid for by private health insurance grew from 29.3 percent to 31.9 percent. (3). While the growth of employer cost containment efforts, Competitive Medical Plans and the Prospective Payment System are having a definite impact, it would seem very conservative to assume that private health insurance will grow no faster than GNP from 1983 to 1986. However, I will make this assumption.

The President's Budget for FY1986 forecasts calendar year 1986 nominal GNP at 30 percent above 1983. Assuming private health insurance grows in the same proportion, one obtains an estimate for shelterable group insurance premiums in 1986 of $133.9 billion.

Until recently, in doing such calculations, it had been normal to estimate or assume that about 80 percent of the group insurance premium was paid by the employer, hence tax sheltered, while about 20 percent was paid by the employee out of net-after-tax income. (4) However, a very important event took place in 1984 when the IRS clarified the status of "cafeteria plans" including "salary reduction" and "flexible spending arrangements" under Section 125 of the Internal Revenue Code. Specifically, employees may have their health insurance premiums paid with pre-tax dollars by their employers through "salary reduction agreements" or "flexible spending accounts." Flexible spending accounts (FSAs) must be on a "forfeitable" or "use it or lose it basis," i.e. the unused amount at the end of the year cannot be returned to the employee. (5)

Salary reduction or FSAs are an ideal device for the employee to use to tax-shelter his or her health insurance premium contribution. Use of this device is spreading very rapidly. The employer has strong incentives to offer it. For one, he can avoid payroll tax on the sheltered amount. Moreover, it breaks the link between "employer contribution" and the tax break, making it easier for the employer to hold down his contribution without denying the tax break to the employee. It is difficult to forecast the speed with which use of this device will spread, but it seems reasonable to suppose that by sometime in 1986, the overwhelming majority of employers other than the Federal Government will be using it. Assuming that 90 percent of the labor force uses it, the tax-sheltered amount of premiums will rise 90 percent of the way from 80 percent to 100 percent, or in other words, 98 percent of premiums in 1986 will be tax sheltered.

The applicable Federal marginal tax rate is calculated as follows:

1. The average Federal marginal income tax rate in 1986 will be 25 percent. (6)

2. 89.3 percent of paid civilian workers are covered by OASDI (7), and 6.1 percent have maximum covered earnings. (8)

If an employer of a covered worker below the FICA taxable maximum diverts $100 from health benefits to the worker's pay, $100/1.0715 or $93.33 will be "salary," the employer and employee will each pay $6.67 in payroll taxes (7.15 percent of salary) and the employee will pay $23.33 in personal income tax, for a total tax of $36.67. Thus, the applicable marginal tax rate is 36.67 percent.

The 10.7 percent of workers not covered by Social Security will have a marginal tax rate of 25 percent.

The 6.1 percent with earnings above the Social Security maximum will pay no payroll taxes at the margin, but the average person in such a position will be in a higher marginal income tax bracket which I assume to be at least 40 percent.

These combine to an average marginal tax rate of 36 percent. In fact, because the distribution of employer paid health benefits is so heavily skewed towards upper income persons, I believe that an accurately weighted average would produce a substantially higher estimate.

Combining the previous estimates with a 36 percent marginal tax rate yields an estimate of $48.2 billion in Federal tax revenue loss in 1986.

This estimate does not yet include the effects of tax sheltering on employee choice of health plan, nor the revenue losses from FSAs used to make out of pocket payments.

The possibility of tax sheltering the employee's contribution to the premium reduces the marginal cost to the employee of a more costly health insurance plan by 36 percent, and must have a substantial effect in inducing demand for more costly health plans. A sophisticated analysis of this effect would require consideration of the full distribution of employer contribution patterns before and after the change in the tax law. Some employers already pay the full premium, and their employees would not be affected. Other employers like the Federal Government pay a fixed dollar amount, and the purchases of those employees would be substantially affected by the change in effective price. However a rough average can be estimated using a finding of Taylor and Wilensky that the elasticity of health insurance premiums with respect to the "price of health insurance" (one minus the marginal tax rate) was -0.21. (9) That is, for example, a 10 percent reduction in price would induce a 2.1 percent increase in spending on premiums. Assume every employer was like the average, with 80 percent of premiums employer paid. Then assume the change in the tax law allows the additional 20 percent to be tax sheltered. If tax sheltering reduces the "price" of that last 20 percent by 36 percent, the amount purchased will increase by 7.6 percent (.21 times .36).

Under the previous rule, 80 percent of the estimated $133.9 billion was tax sheltered, or $107.1 billion. Assuming an additional 18 percent or $24.1 billion becomes tax sheltered, and making the very conservative calculation that only this amount is affected, the "induced demand" is 7.6 percent of this amount or another $1.8 billion. So the shelterable premiums rise to $135.7 billion and the revenue loss rises to $48.9 billion. (A more refined calculation would produce a higher estimate.)

Before proceeding, it might be useful to compare this estimate to others developedby official agencies. In May 1982, the CBO projected the 1987 revenue loss at $45.8 billion. (10) One only needs to note that this estimate was prepared before estimates of private health insurance volume were revised upward by 18 percent and before the May 1984 ruling on Cafeteria Plans. Thus, there is no inconsistency.

In Special Analysis G of the FY1986 Budget of the United States Government, the Treasury estimates the 1986 revenue loss from exclusion of employer contributions for medical insurance premiums and medical care at $23.7 billion. The first thing to say about this is that it ignores payroll tax revenues. Including them would raise the estimate to about $34.1 billion. This is still far too low. An examination of the history of Treasury estimates makes it apparent that the estimate in the Special Analysis for the Fiscal Year 1986 did not take account either of the 18 percent upward revision in the estimated volume of private health insurance nor of the IRS ruling of May 1984. For example, the estimated revenue loss for 1985 in the FY 1986 Special Analysis was only 5.4 percent above the estimate for 1985 in the FY 1985 Special Analysis, prepared before these two very important events.

Roughly speaking, the 18 percent upward revision in private health insurance should correspond to an 18 percent revision in revenue loss. A change that increases the percent of group insurance premiums that is tax sheltered from 80 to 98 should raise the revenue loss 22.5 percent. The combined effect should then be a 44.6 percent increase. Apply that to the $34.1 billion Treasury estimate (with payroll tax added), and one obtains a revenue loss of $49.3 billion which is about the same as mine.

So far, I have considered only the effects of tax sheltering health insurance premiums. The next section of this analysis considers the potential revenue loss from the use of FSAs to shelter out-of-pocket expenses. This section is inevitably much more speculative than the first part of this analysis. I hope that researchers with access to more detailed data resources will be able to do this more precisely.

The FSA, even of the "forfeiting" variety opens up very large potential revenue losses to the Treasury. It is reasonable to suppose that given a little time to get used to the idea and a normal amount of American ingenuity, most regularly employed Americans will figure out how to get most of their health care spending paid for with pre-tax dollars via FSAs. The "forfeiting" restriction is likely to end up being much less restrictive than appears at first glance.

Consider the opportunity as seen by the employed head of a household. Let us say it is December and he or she must direct his or her employer to reduce his or her salary by a specified amount and put that into a medical FSA. The employee estimates the family's needs. First, how many bills from the present year remain unpaid because this year's FSA was exhausted? They can be paid next year. Next, many expenditures can be planned for the coming year. Most surgery is elective with respect to timing. Cosmetic surgery not normally covered by insurance can be planned and included in the FSA. Also coinsurance and deductibles can be paid out of the FSA, as can glasses, hearing aids, drugs, etc. An estimate is made. In considering the dangers of overestimating, the taxpayer knows that if the end of the year is approaching, he can decide to accelerate payments to some providers or start some elective treatments earlier (e.g. have the children's eyes examined and buy new glasses). Underestimates can be compensated by delaying payment to the next year.

How large are expenses that are potentially shelterable? In 1983, direct payments for personal health care came to $85.2 billion or $350 per capita (3). Of this, $27.3 billion was associated with persons 65 or over.

(11) About $55 billion was associated with under 65s, not counting nursing home expenditures. This was $266 per capita.

It is difficult to estimate from aggregate data how much of this is associated with upper income households that are likely to use FSAs and benefit from the tax shelter. Unfortunately sickness, poverty, and lack of insurance are all correlated with each other, so poor people are more likely to be hit by out-of-pocket costs not covered by insurance. Pamela Farley found that in 1977, 15.3 percent of the poor and near poor who had some private insurance had out-of-pocket expenses of $200 or more compared to 8.8 percent for high income families. (12) On the other hand, upper income families can afford more things like new eyeglasses and cosmetic surgery. Altogether, Farley found that 8.8 percent of upper income insured families had out-of-pocket expenses of $200 or more compared to 8.1 percent for insured families generally. Assume then that, as a rough approximation, out- of pocket payments are distributed evenly across income classes (though this does need to be refined).

Suppose only those with above average incomes use FSAs. Then half or $27.5 billion of the $55 billion is shelterable. At a 36 percent marginal tax rate, at 1983 spending levels this would be $9.9 billion; at 1986 levels, $12.9 billion. This estimate needs to be adjusted for at least two more factors. One is the increased amount demanded because of reduced net price to consumers. This is not easy to estimate because the effect of the FSA on net price will be different for different services. For example, if the household pays 25 percent coinsurance, the FSA might reduce the net pprice of a $1000 procedure from $250 to $160. But for an uninsured item, it would reduce the cost from $1000 to $640. For an upper income family, the FSA would reduce the price to $500. The RAND study would suggest that a FSA for a person in the 36 percent bracket would increase spending on items previously uninsured by about 9 percent. (13) This would increase the revenue loss. On the other hand, the effect could be stronger. In the last quarter of the year, persons facing a loss under the "forfeiture" provision might buy two new pairs of glasses they otherwise wouldn't have purchased. Simulating all this is a complex problem. Yet on the other hand, one can expect some slippage in the use of FSAs as people do less than a perfect job of using them. Even a generous estimate of an assumption that people are only 80 percent effective in use of FSAs, combined with a 9 percent increase because of demand elasticity would leave this source of revenue loss at $11.2 billion. Of course if more employers and employees learn to make use of this, the loss could be much higher.

(1) Ross H. Arnett, III, and Gordon R. Trapnell, "Private health insurance: New measures of a complex and changing industry," *Health Care Financing Review*, Winter 1984.

(2) Pamela J. Farley, "Private Insurance and Public Programs" coverage of Health Services," National Center for Health Services Research, Data Preview 20, DHHS Publication No. (PHS) 85-3374.

(3) Robert M. Gibson *et al.*, "National Health Expenditures, 1983," *Health Care Financing Review*, Winter, 1984.

(4) See, for example, Amy K. Taylor and Walter R. Lawson, Jr., "Employer and Employee Expenditures for Private Health Insurance," NCHSR National health Care Expenditures Study, Data Preview 7, June 1981, HHS Pub. No (PHS) 81-3297. They found on average that the employer paid 80.4 percent.

(5) IRS News Release IR-84-22 February 10, 1984, and *Federal Register*, May 7, 1984.

(6) Personal communication, Sonia Conley, U.S. Treasury. See also John A. Tatom, "The 1981 Personal Income Tax Cuts: A retrospective Look at their Effects on the Federal Tax Burden," *Review*, Federal Reserve Bank of St. Louis, December 1984.

(7) *Statistical Abstract of the United States 1985*, p. 360. Data for 1982.

(8) *Social Security Bulletin Annual Statistical Supplement, 1983*, p. 78. Data for 1983.

(9) Amy K. Taylor and Gail R. Wilensky, "The effect of Tax Policies on Expenditures for Private Health Insurance," in Jack A. Meyer, ed., *Market Reforms in Health Care*, AEI Washington 1983.

(10) Paul B. Ginsburg, Containing Medical Care Costs Through Market Forces, Congress of the United States, Congressional Budget Office, Washington, May 1982.

(11) Daniel Waldo and Helen Lazenby, "Demographic Characteristics and Health Care Use and Expenditures in the United States: 1977-1984," *Health Care Financing Review*, Fall 1984. Data in the article are for 1984, which I have reduced to 1983 amounts by the growth of GNP, or 10.8 percent.

(12) Pamela J. Farley, "Who Are the Underinsured?" NCHSR National Health Care Expenditures Study, November 1984.

(13) Joseph P. Newhouse, *et. al.*, Some Interim Results from a Controlled Trial Cost Sharing in Health Insurance, RAND Corp. R-2847-HHS, January 1982.

A NEW PROPOSAL TO REFORM THE TAX TREATMENT OF HEALTH INSURANCE

by Alain C. Enthoven

Prologue: *For the better part of a decade, Prof. Alain Enthoven of the Stanford University Graduate School of Business has been at the forefront of a growing movement to infuse the delivery of medical care with a structured form of price competition. Enthoven, an economist by academic training, has provided the intellectual lifeblood to this movement, educating a cadre of students who increasingly are finding their way into positions of influence, and impacting on the thinking of policymakers like former House Ways and Means Chairman Al Ullman (D-Ore.), Sen. David Durenberger (R-Minn.), Rep. Richard A. Gephardt (D-Mo.), and former Rep. David Stockman (R-Mich.). Enthoven, who set out his beliefs in a book entitled* Health Plan: The Only Practical Solution to the Soaring Cost of Medical Care, *published in 1980, has been steadfast in his belief that the most appropriate remedy is not more bureaucratic controls imposed on, as he characterized it, "an inherently irrational system," but rather fundamental reform of the financing and delivery system itself. As he explained in his book, ". . . we need to change from today's system dominated by cost-increasing incentives to a system in which providers are rewarded for finding ways to give better care at less cost." Enthoven believes that government's role in this regard is not reorganization of the health care system by direct controls—as advocated recently in a presidential campaign speech by Democrat Walter F. Mondale—but changing the tax laws and Medicare and Medicaid laws that create the underlying incentives. Enthoven, a member of the Institute of Medicine of the National Academy of Sciences, was assistant secretary of defense under former Secretary Robert McNamara and has also served as president of Litton Medical Products.*

The present favorable tax treatment of employer contributions to employee health benefits costs federal and state governments a large amount in foregone tax revenues—about $30 billion in 1983. While tax incentives to purchase health insurance are desirable, there are four major problems with the present way the tax incentives are provided. First, it reinforces the cost-increasing incentives in our health care financing system and weakens consumer cost consciousness. Second, the distribution of the tax subsidies to health insurance is regressive. The present system provides substantial benefits for upper-income employed people, much less for low-income employees, and little or nothing for many self-employed, unemployed, and working poor. Third, the revenue loss to the government is growing much faster than the Gross National Product (GNP), thus contributing to the growing deficit. And fourth, the present system unnecessarily reinforces the link between jobs and health insurance

In recent years, several congressional leaders have proposed a limit on tax-free employer contributions to employee health insurance and health benefits. The list includes Senator David Durenberger and Congressmen Richard Gephardt, James Jones, David Stockman, and Al Ullman. In 1983, the Reagan administration proposed a limit of $175 per month for family coverage and $70 per month for individual coverage, beginning in January 1984.[1] This limit would be increased annually in proportion to the Consumer Price Index (CPI).

The enactment of such a tax cap would be an important step in the right direction. It deserves support on its own merits. But there is an even better way to reform the tax treatment of health insurance, one that more effectively addresses all of the major defects of the present system: that is to replace the present exclusion of employer contributions from the taxable incomes of employees with *a refundable tax credit.* This tax credit would be equal to 40 percent of each taxpayer's health insurance premium payments to a qualified health care financing and delivery plan up to a limit on tax-subsidized premiums of $150 per family or $60 per individual in 1983 dollars. (This would be approximately the same as the Reagan administration's proposed limit expressed in 1984 dollars.) A qualified plan would have to meet certain federal standards which will be discussed later in this paper.

This refundable tax credit would be available to all legal residents regardless of job status or employer contribution. The limit should be increased annually in proportion to GNP per capita in order to stabilize the government's revenue loss as a share of GNP. This would replace a large and growing revenue loss that is tied to what amounts to open-ended entitlements in the private sector with a finite sum tied to the

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growth of GNP. It would equalize the subsidy—or incentive to insure—across the income classes. It would assist the self-employed, the unemployed, and the working poor to buy health insurance. Additional steps would be needed to assure universal access to affordable health insurance, but this would be a large step toward universal health insurance. The initial cost to the federal budget would not be large; the eventual savings would be.

The Present Tax Treatment Of Health Insurance

The Internal Revenue Code of 1954 excluded employer contributions to the health insurance and health care of employees from the incomes of employees subject to federal income and payroll taxes.[2] The states with personal income taxes have done the same. It is a safe bet that in 1954 nobody had any idea that Congress was enacting what twenty years later would become the second largest and one of the fastest growing federal health insurance programs. In FY 1975, according to Congressional Budget Office (CBO) estimates, the exclusion cost the federal budget $6.9 billion; by 1983 it was $25.7 billion.[3] These amounts and their growth are compared with Medicare and Medicaid in Exhibit 1. In addition, Amy Taylor and Gail Wilensky estimated that in 1983 the exclusion cost states $3.8 billion in lost tax revenue.[4] CBO has projected that by FY 1987, the loss to the federal budget will be $45.8 billion.

Exhibit 1
Growth In Federal Outlays And Tax Subsidies For Selected Health Insurance Programs (Billions of Dollars)

	FY 1975	FY 1983	Ratio 1983/1975
Medicare (a)	$14.8	$57.4	3.9
Federal Medicaid (a)	6.8	19.3	2.8
Exclusion (b)	6.9	25.7	3.7

Sources: (a) *The Budget of the United States Government*, 1977 and 1984; (b) Congressional Budget Office, *Containing Medical Care Costs Through Market Forces*, May 1982.

The favorable tax treatment of employer-provided health insurance has had the very beneficial effect of motivating the rapid growth of private insurance coverage. In 1950, seventy-seven million Americans, or half the population, had some insurance against at least hospital expense. By 1980, the number had increased to 189 million or 85 percent of the population.[5] Data from the National Health Care Expenditures Study indicated that by 1977, 88.3 percent of employees in the United States worked for employers that offered health insurance plans.[6] And the scope and depth of coverage of these plans have increased greatly.

A purely voluntary system of health insurance, based on individual decisions as to whether and how much to insure, would not produce results that would be acceptable in our society. In the absence of either compulsory health insurance or, what is almost the same thing, powerful financial incentives provided by government for people to buy insurance, the possibility of widespread health insurance would be destroyed by the process of adverse risk selection. Most medical care is elective with respect to timing. And individuals have private information about their health status and prospective health care needs that could be available to insurers only at very great cost, if at all. In a health insurance market made up solely of individual purchasers, and in the absence of powerful incentives for the healthy to purchase insurance (such as the tax subsidy in the exclusion), many individuals who expected no medical costs would either not insure at all or buy only insurance with very high deductibles and low premiums. Only those expecting medical expenses would buy insurance with low deductibles. When the well got sick, they would attempt to buy insurance. However, many would be unable to purchase insurance because insurers would exclude coverage for care of preexisting medical conditions. Premiums would be driven up to prohibitive levels, and insurance would become unavailable to many. Indeed, today the uninsured are heavily concentrated among those who do not belong to an employee group.[7] This process would be exacerbated in our society by what economists call "the free-rider problem." Many people who expected no medical costs would not buy insurance and, instead, would plan to fall back on the public sector for care if they became seriously ill.

We could deal with these problems by a system of compulsory universal insurance financed directly by government, as in Canada or the United Kingdom. But in our country, we have chosen to deal with these problems, in the case of those who are neither aged nor poor, by a system of tax subsidies for the purchase of private health insurance, the effect of which makes it attractive for the healthy to insure. Thus, the issue is not the need for some form of tax subsidy. The issues are its form and distribution. It would be a serious mistake to propose the elimination of all tax subsidies for health insurance.

Defects In The Present Form Of Tax Subsidy

In its present form, the tax subsidy for health insurance has several serious defects. First, the present system reinforces the cost-increasing incentives in the health care financing and delivery system. In a group of average taxpayers, if the employer were to increase pay by $100 per year, about $40 would go to federal income and payroll taxes and state income taxes.[8] If instead the employer were to raise the health benefits contribution by $100 per employee, the full $100 would go to health benefits.

The typical response is for employers and employees to agree that the employer will pay most or all of the employee's health insurance premiums with pretax dollars rather than paying the employee the equivalent amount in cash and leaving the employee to pay the premiums with net after-tax dollars. The incentive is also to cover very comprehensive benefits, including, for example, routine dental expenses, in the insurance plan so that even routine expenses will be paid with pretax dollars. For example, the number of persons covered by dental expense insurance increased from about twelve million in 1970 to over eighty million in 1980.[9] Amy Taylor and Gail Wilensky have estimated that "employers pay 100 percent of the premium for almost half of the subscribers."[10] The consequence has been to destroy the cost consciousness of the individual employee in medical purchasing decisions.

During the 1970s, as this process took place, more and more employers became committed to 100 percent payment of the cost of a comprehensive fee-for-service, free-choice-of-doctor insurance plan. As economical health maintenance organizations (HMOs) with lower premium costs than their traditional insurance competitors grew and became more widely available, it might have seemed rational for employers to peg their contributions to the cost of membership in an HMO, and to let the employees who wanted to do so pay the extra cost of the most costly plan themselves. However, only a minority of employers have done this. Most employers have been exceedingly reluctant to go back on a previously granted "entitlement." As a consequence, employees in such groups have little or no financial incentive to join an economical HMO.

Health insurance benefits have provided union leaders with a generous supply of bargaining prizes. Perhaps the union members who are less schooled in economic reasoning actually believe that it is the employer who is paying for these benefits, rather than employees in the form of reduced wages. On the other hand, those who are more schooled in economics probably recognize that health benefits are paid out of what would otherwise be wages, but they also recognize the large tax subsidy. Thus, the open-ended tax exclusion has given union leaders an additional and powerful incentive to bargain for 100 percent employer payment of a comprehensive package of benefits.

A new approach is needed to encourage employers and unions to reconsider these patterns of behavior. A change in the tax laws that limits the amount of employer contribution that could be tax free to the employee would help.

The second major problem with the exclusion in its present form is that it is regressive, and that it treats people of similar incomes and health insurance purchases differently merely by virtue of employment status. Paul Ginsburg estimated that in 1983 the exclusion was worth $83 or .65 percent of income for households with incomes from $10,000 to $15,000, but $622 or .98 percent of income for households with incomes between $50,000 and $100,000. Part of the reason for this is that employer contributions are larger for the higher-paid group: an average of $2,025 versus $972 for households in these income categories receiving employer contributions. Employers of higher-income employees are much more likely to make contributions: 73 percent of households versus 31 percent for the two groups.[11] Part of the reason for this difference is that exclusions are worth more per dollar to people in higher tax brackets. Not only does this distribution of federal health insurance subsidies across the income classes seem inappropriate, but also there are "horizontal inequities." The present form of the exclusion does nothing for the self-employed or many other people who need and buy health insurance but do not have an employer contribution.

Of course, any tax deduction or exclusion will be more valuable to upper-income people because they pay taxes at higher rates. And one cannot make a fair appraisal of the equity of a particular provision of the tax code without considering the impact of the code in its entirety.

But, in effect, the tax exclusion has become a health insurance program, and it needs to be considered from the point of view of society's values concerning access to health care. It appears that we have a national consensus that everyone should have financial access to good quality health care and to health insurance at reasonable rates. Congress has expressed that in enactment of Medicare and Medicaid, other programs for special groups, continuation of the tax subsidy for the employed, and in attempts to pass health insurance programs for the unemployed. Nobody defends gaps in health insurance coverage. Yet, the present form of the tax subsidy encourages upper-income employed people to buy more health insurance while failing to help many who need it most, such as intermittently employed and self-employed persons. The irony is compounded by the fact that many low-income people without health insurance fall back on the public sector when seriously ill so that the taxpayers pay for their care anyway. It would make more sense to facilitate their purchase of private insurance in order to help them not become a burden on the public sector.

As noted earlier, a free unsubsidized market of health insurance for individuals breaks down because of adverse risk selection. To counteract this, a powerful financial incentive is needed to encourage the healthy to insure. Such an incentive is available to employed people. What rational basis can there be for denying the same benefit to those who are not employed?

The third major defect in the present form of the tax subsidy for health insurance is that the revenue loss to the federal government, already large, is growing much faster than the GNP. Paul Ginsburg estimated that the federal revenue loss increased from $3.2 billion, or .34 percent of GNP in FY 1970, to $19.8 billion, or .7 percent of GNP in FY 1981.[12] This growth in relation to GNP has occurred for several reasons. First, health spending has grown faster than GNP, for example, from 7.5 percent of GNP in 1970 to 9.8 percent in 1981. Second, there have been marked increases in the scope of private health insurance. For instance, in 1970, as noted earlier, about twelve million persons had insurance for dental expense. By 1980, the number exceeded eighty million. And third, payroll tax rates have increased, and effective marginal income tax rates have increased as people were pushed into higher marginal tax brackets both by inflation and gains in real income. While the reduction in tax rates and the indexing of the tax brackets in the Economic Recovery Tax Act of 1981 (ERTA) will presumably stop the "bracket creep" associated with inflation, the other factors, including already-legislated future increases in payroll tax rates, will continue to increase the revenue loss if no corrective action is taken. In the future, this will become a more serious problem for the federal government than it has been in the past because ERTA deprived it of inflation-induced "bracket creep" as a source of revenue growth. ERTA will limit the growth in federal income tax revenue as a share of GNP to that which comes from growth in real per capita income.

The growth in this source of revenue loss is likely to be exacerbated by provisions of the Tax Equity and Fiscal Responsibility Act (TEFRA) and the Social Security Amendments of 1983. In that legislation, Congress limited the growth in the amount per Medicare inpatient case that Medicare will pay to "market basket plus one percent," at least through 1985. At the same time, some states are engaging in selective contracting with hospitals at negotiated rates for Medicaid cases. If employers continue to make open-ended payments for fee-for-service medical care and for hospital charges on a non-negotiated, free-choice-of-provider basis, hospitals are likely to try to shift costs not paid by Medicare and Medicaid onto private payers. In that event, if government does not limit its tax subsidy to employer-provided health insurance, it is likely to end up paying 40 percent of the shifted costs through tax revenue losses. Government will become the main victim of the cost shift!

Finally, the present form of the exclusion reinforces the link between jobs and health insurance. This link adds greatly to the complexity of the health insurance market. For example, many people lose their health insurance when they lose their jobs. Those who work for an employer who self-insures or who buys an experience-rated policy from an insurance company are not likely to be able to continue their health insurance at their own expense, or if they are, it will not be at anything close to the group rate. HMO members who leave their employment group can continue their membership by continuing on their own to pay the community rate. But if an HMO member changes jobs and switches to an employer who does not offer the HMO to his employees, the member is likely to be forced to change HMO and, probably, change doctors. A different form of the tax subsidy could ameliorate these problems considerably.

If one counts the tax subsidies, government is now paying about half the total cost of health care services. Yet we still do not have universal health insurance. Millions of people who do not belong to employment groups are denied the opportunity to buy health insurance and denied the subsidies available to employed people if they are able to buy insurance. Think of the problems of a widow or divorcee in less than perfect health who depended on her husband's employment group for health insurance. She is likely to become uninsurable or at least have coverage that excludes treatment for pre-existing medical conditions. In addition, she is denied a tax subsidy for health insurance. Can anyone put forward a rational defense of such a state of affairs? The plain fact is that our present system is an historical accident that is very hard to change because large numbers of influential people have a vested interest in the status quo. Congressional efforts to extend health insurance to the unemployed have failed, mainly because of budgetary problems, but also because of the problems of complexity of job-related health insurance and the lack of subsidies to support health insurance for unemployed people. We ought to be moving in the direction of universal health insurance, at least in the minimal sense of assuring each person the opportunity to buy health insurance at approximately a group rate.

The Proposed Reform

Congress ought to go beyond the tax cap and provide that every resident may receive a refundable tax credit equal to 40 percent of his or her own or the employer's health insurance premium payments to a health insurance plan meeting federal standards, up to a limit on subsidized premiums such as $150 per family or $60 per individual per month, in 1983 dollars. This would entirely replace the present exclusion. Employer payments would be included in the taxable income of the employee reports on Form W-2. A line would be added to the tax credit section of Form 1040. To substantiate the credit, the taxpayer would staple to the form a "Form H-2," a receipt from a qualified health plan. A "refundable tax credit" means that the taxpayer's liability is reduced by the amount of the credit, and in the event that the taxpayer's liability not counting the credit is less than the credit, the difference is refunded to the taxpayer in cash.

The credit would not be available to beneficiaries of Medicare and Medicaid. For persons covered by those programs for part of the year, the tax credit would be available for the months during which they were not covered by those programs. The tax treatment of employer-paid health benefits for retired Medicare beneficiaries would not be changed by this proposal, but it should be reviewed and considered in its relationship to the Medicare program.

The limit would be increased each year in proportion to GNP per capita in order to adjust for inflation and to stabilize the cost to the government as a share of GNP. Since GNP per capita goes up faster than inflation, this allows for inflation plus an additional amount to help offset the effects of an aging population and advancing technology. (More precisely, the limit should be increased each year in the same percentage as the average change in GNP per capita over the past five years, in order to smooth out fluctuations.)

Reasons For The Proposal

First, this proposal would give everyone—including the healthy—a strong incentive to insure up to the limit, but a disincentive to buy a health insurance plan costing more than the limit. Those who bought less than the limit would be walking away from a subsidy. A family that did not insure would be turning down a $60-per-month subsidy (40 percent of $150). This incentive would be likely to attenuate the problem of adverse risk selection, described earlier, that makes it so hard to make health insurance available to individuals not part of an employment group, by giving healthy people an incentive to keep their insurance. However, it is not possible to predict, with presently available data, how effective this incentive would be. At the same time, this proposal would make every purchaser cost conscious in the choice of health care plan, and liable for the full premium cost above the subsidized limit. Families considering health plan alternatives with costs at or above the limit would be able to keep for themselves the full savings generated by the decision to choose the less costly alternative. Thus, enactment of this proposal would expand the demand for membership in cost-effective health care financing and delivery plans.

Second, this proposal would equalize the subsidy for health insurance across the income classes. The subsidy and the incentive to insure would become the same for high-income and low-income families. (Additional subsidies would be desirable for low-income families, but that issue could be considered separately and perhaps at the level of state and local government.) This proposal would treat equally two taxpayers with the same income and health plan, one of whom happens to have an employer while the other is self-employed. This proposal would also give the unemployed the opportunity to keep the health insurance they had when they were employed.

Third, this proposal would replace what amounts to an unlimited federal subsidy of privately negotiated open-ended entitlements with fixed-dollar subsidies that would grow at the same rate as the GNP. *Thus, it would help to balance the budget in the long run.*

Why should the limit be around $150 per family per month in 1983 or $175 in 1984? The idea is to provide every family an incentive to subscribe to a good quality comprehensive but economical health care financing and delivery plan. Ideally, from a health insurance point of view, if we were dealing with a single market, the limit would be set at the price of the least costly comprehensive health care financing and delivery plan. That would assure everyone subsidized access to comprehensive care. However, there are other factors to consider including regional variations and political judgments about support and priorities. For 1984, $175 was the Reagan administration's choice. A similar approach would be that used in Sen. David Durenberger's Health Incentives Reform Act of 1979: a limit equal to the average premium cost for federally-qualified HMOs.[13] That stood at about $172 per family per month in mid-1983, which, when adjusted for inflation, would yield a somewhat higher figure for 1984. However, there is no compelling reason why the limit must match 100 percent of the average HMO premium.

Why make the credit 40 percent of the limit? This is a judgment call reflecting several factors. First, 40 percent is approximately the average marginal tax rate, including both income and payroll taxes. Thus, the position of the average taxpayer belonging to a 100 percent employer-paid plan with a premium at the limit would be unchanged. Lower income people would gain, above-average-income people would lose. Second, a substantial subsidy, about that large in my judgment, would be needed to motivate most healthy people to buy fairly comprehensive insurance plans, and thus combat the adverse risk selection problem described earlier. If cost and budgetary considerations rule this out, Congress might try a lower percent as an alternative. Somewhere not far below 40 percent, a "budget neutral" proposal could be designed.

Why should the tax credit be refundable? The purpose of the proposal is to encourage low-income people to insure even if they have little or no tax liability. The limit should be applied to the tax-paying unit—the individual or couple filing a joint return—and not to the employer. There are millions of two-earner households, even millions of two-job people. As a result, roughly fifty million people have duplicate coverage which is costly and can defeat the cost-reducing incentive effects of coinsurance.[14] Some people collect duplicate insurance payments and don't pay tax on them. A family doesn't need two $150-per-month tax shelters; one per family is enough.

Should there be regional adjustments to reflect differences in factor costs? This is essentially a political question. The proposal ought to be enacted with or without regional adjustments for factor costs. Regional adjustments have often been proposed and debated. One reason for them is to prevent hardships for people in high-cost areas, and windfalls for people in low-cost areas. Another is to give recognition to the fact that, at equal tax rates, people in higher wage areas pay higher taxes. On the other side, there is no precedent for regional adjustments in the tax laws. To create regional adjustments in the tax credit, it is argued, would open Pandora's Box and unleash a free-for-all scramble for all sorts of regional preferences. Another argument for uniformity is that regional variation would add to complexity of administration. However, it would not need to be more complicated than a table of limits by state in the tax-return instructions. Finally, one could argue that the uniform limit hits hardest where needed most, in the high-cost areas.

In the new Medicare system of prospective payment to hospitals by diagnosis-related group (DRG), regional hospital wage differentials are recognized and will be allowed to persist. Personally, I would prefer to see Congress define the tax credit as a health insurance program and allow regional variations for factor costs. But I do not think the value of this proposal depends critically on that provision.

Why index the limit to GNP per capita? The overall CPI has been criticized as overly sensitive to such factors as the impact of interest rates on housing costs. The trouble with using the medical care component of the CPI is that this would help reinforce the inflationary cycle. The use of GNP per capita instead of the GNP deflator recognizes that such factors as advancing technology and an aging population create valid reasons for increasing real per capita spending, and that stabilizing health care spending as a share of GNP is a sufficiently ambitious goal. Congress could review this periodically in relation to other priorities.

Additional Reforms That Could Be Tied To Tax Credits

While the change in the tax treatment of health insurance could stand on its own merits, I would recommend tying it to some other changes intended to promote universality and continuity of coverage and to facilitate competition among health plans. In order for premium payments to be eligible for the refundable tax credit, health care financing and delivery plans should have to meet certain standards.

First, a qualified plan should be required to offer people who leave an employment group the right to purchase the same coverage at their own expense at rates not to exceed, for example, 110 percent of the group rate, the excess to cover extra administrative costs. The same right should be available to dependents who lost coverage because of death or loss of employment of the employee, divorce from the employee, or loss of dependent status because of age or graduation from college. This right should be exercisable without medical review or exclusion of coverage for pre-existing medical conditions. (The employer's obligation could be cancelled by the employee's joining another employee group offering a qualified health insurance plan.) Self-insured employers could discharge this obligation by providing the coverage themselves or by contracting for it with an insurance carrier. I recognize that such a requirement is not without cost to employers. But continuity of coverage is an important social purpose that government would be paying to achieve by the tax subsidy.

The main argument against such a requirement is that the per capita costs of insuring people who leave an employment group are quickly driven up by adverse risk selection. People who lose their jobs and don't expect any medical needs drop their health insurance, while those expecting to need medical care keep theirs. One of the purposes of the proposed tax credit is to attenuate this process of adverse risk selection by giving healthy people an incentive to continue their insurance. If necessary, Congress could compromise the implementation of this principle by enacting a time limit such as a year.

Additional measures would be required to assure universal availability of health insurance. But continued subsidies to people leaving employment groups and continuation of their right to buy insurance at approximately the group rates would be a major step in the right direction. Congress and/or state legislatures might consider a subsequent step of contracting with HMOs and insurers to offer insurance to persons not eligible for group coverage, while subsidizing the excess risk component of the cost of such coverage. (That is, insuring people who are not members of a group costs more than insuring a group of similar age-sex composition because of the adverse risk selection associated with individual coverage. Estimates of this excess risk component can be made by reference to the average cost of insuring group members. A government agency could negotiate to pay a subsidy to a health plan to induce it to offer coverage to individuals at group rates.)

It is worth noting that HMOs presently allow members who leave their employment group to continue their coverage at their own expense at the community rate. Because I belong to an HMO, my child can purchase individual coverage at the community rate without medical review or exclusions for pre-existing medical conditions when he or she ceases to be my dependent. The same would be true of my widow in the event of my death. Congress should require that whatever health insurance contribution an employer makes should be equally available to a new employee who wishes to retain membership in his HMO, whether or not the employer offers coverage by that HMO.

Continuity of coverage standards should include the requirement that coverage for dependent children begins automatically at the time of birth or adoption, and that employer group plans contain no exclusions or restrictions on coverage based on pre-existing medical conditions. Exclusion of coverage of care for pre-existing medical conditions is a means that health insurance companies use to protect themselves from medical costs of chronically ill people and from "the free-rider problem," in which people do not buy health insurance until they become sick. While understandable from an individual company point of view, this practice is indefensible from a social point of view. It means denying health insurance to the people who need it most. If there were a general ban on exclusion of care for pre-existing conditions, individual companies would not need to suffer a worsened competitive position by dropping such exclusions. Similar continuity of coverage provisions were included in Sen. David Durenberger's Health Incentives Reform Act, first introduced in 1979.[15]

Next, every qualified plan should be required to meet at least a common standard of services covered and limits on out-of-pocket payments. The standards defined by the HMO Act of 1973 would be a good point of reference. However, many people would feel that the HMO Act and regulations define a coverage that is too costly and comprehensive. If Congress were to decide that this is the case, it could adopt a less costly standard. But to achieve a fair competitive market, all qualified health plans, including HMOs, should be required to meet the same standard. Because of the problem of risk selection in a competitive market, choice of benefit package has to be a social and not an individual decision. Health plans that wish to offer more extensive benefits may do so, but at their own risk of attracting an adverse selection of health risks attracted by the more generous benefits.

There are several reasons for requiring a common standard of coverage or "benefit package." The first is to prevent deceptive or inadequate coverage, "swiss cheese" insurance policies with gaps in coverage that insureds only discover when they need health insurance. (An example would be coverage of newborns not beginning until ten days after birth.) The second is to discourage the use of the benefit package as a tool to select preferred risks. One insurance plan can always select better risks than another by offering a higher deductible and lower premium. Those consumers not expecting to need medical care will find it to their advantage to take the lower premium. Eventually, only health plans with very high deductibles would survive. Third, health insurance policies are very difficult to understand and compare. If left without controls, insurers can differentiate their policies in such a way as to make valid price comparisons very costly. A simple way to focus competition on price, quality, and accessibility of care and service is to standardize most of the fine print that most people can't understand and can't remember anyway.

Cost To The Federal Budget

The following estimates of costs and savings are based on 1983 levels of spending and assume a 1983 limit on subsidized premiums of $150 per month for a couple filing a joint return and $60 per month for an individual.

Several assumptions need to be specified. First, these estimates assume that the limit is applied to each taxpaying unit, as I have described above. Second, this proposal includes no change in the tax treatment of employer-paid insurance for Medicare beneficiaries and their supplemental policies. Third, Medicaid beneficiaries would be unaffected by this proposal. They would not receive tax credits in the months in which they are covered by Medicaid.

The gross cost of the tax credits in 1983 dollars, assuming the 1983 pattern of health insurance premium expenditures, would be $31.1 billion.[16] If we assumed that every eligible person were to take full advantage of the credits—a state that would require at least several years to be reached—the gross cost in 1983 dollars would be $38.4 billion.

Offsetting these costs would be the increases in tax revenue realized by including all employer contributions in the taxable incomes of employees. The increased federal income tax revenues at 1983 levels would be $19.5 billion. The increase in federal payroll tax revenues would be $6.5 billion.[17] Assuming all states with personal income taxes followed suit, increased state income tax receipts would be $3.8 billion. The federal government would need to negotiate with the states to recapture these savings by making offsetting reductions in grants to states. The estimated impact on the federal budget would depend on what one assumes about the action of Congress to recapture these revenues.

Combining these numbers, one can derive a "worst case" first-year estimate of the cost to the federal budget of $12.4 billion, that is $38.4 billion (assuming all eligible people take full advantage) less $26 billion (assuming Congress does not recapture the increased state income tax revenues). And similarly, on the opposite assumptions, one can derive a "best case" estimate of $1.3 billion, that is $31.1 billion less $29.8 billion.

I believe the "best case" is closer to the truth at the outset, because Congress could, in effect, recapture the increased revenues of the states by offsetting reductions in grants, and because it would take several years for all eligible people not now insured to find ways of obtaining health insurance. Moreover, under this proposal, the revenue loss from the present unlimited exclusion, which is growing at a rate that about doubles its share of GNP in a decade, would be replaced by a tax credit keyed to grow with the GNP. Thus, whatever net revenue loss there might be at the outset should be regarded as a modest investment to achieve important long-run savings.

And if Congress were still not satisfied with that, it could phase in the tax credit, starting with, perhaps, 35 percent instead of 40 percent of premium payments, or with a lower limit on the subsidized premiums. In other words, as noted earlier, a version of this proposal could be devised that would be "budget neutral" in the short run and cost saving in the long run.

Some Problems With The Proposal

As is the case with any proposed change in public policy, this one is not without its problems. First, what about high-risk groups, people who have high premium costs because they are older or in occupations that lead to high medical needs? A limit on the tax subsidy could penalize them unfairly. To solve this problem, it would be necessary to vary the subsidies by actuarial rating category and to require every health plan to practice community rating by actuarial category. I proposed this in Consumer Choice Health Plan.[18] Community rating means charging the same premium for the same benefits regardless of the health status of the groups or individuals covered. Under a scheme of community rating by actuarial category, the population is divided into groups based on factors that predict medical need. Health plans can charge higher premiums for covering people in higher risk categories. This compensates the health plan for serving people in higher risk categories. These people, in turn, can be protected from the burden of higher costs by the government paying proportionately higher subsidies on their behalf. The best example of this idea in actual operation is the recently tested and enacted system under which Medicare pays HMOs for caring for its beneficiaries. Medicare will pay the HMO 95 percent of the Adjusted Average Per Capita Cost (AAPCC), which is the average cost to Medicare of similar persons who remain with fee-for-service, considering age, sex, location, institutional status, and other factors. Some kind of system to compensate health plans for serving higher risk persons, while protecting the patients from the higher costs, is a necessary part of any system of fair economic competition of health care plans. It might be appropriate to begin with a simple stratification based on subscriber's age, such as under/over forty-five, and eventually phase in a more refined system.

Next, there is the question of probable employer response. Under the "tax cap" proposal, I believe the most probable response of employers now contributing more than the limit would be to make fixed-dollar contributions to employee health insurance at the tax-free limit, and to pay the employees the rest of what they were contributing in cash. Under the "tax credit" proposal, employer payments for health insurance would be included in the employee's taxable incomes. So employers might just as well pay the employees cash as health insurance contributions. Would this destroy the employer incentive to organize health insurance for employees? Or would it cause employers to lose interest in what health insurance costs? I think not. Availability of good health insurance options would remain an attractive fringe benefit employers would want to offer to attract employees.

Next, there is the problem of windfall loss for those employees now receiving large employer contributions to costly health plans. Some auto workers, for example, are receiving employer contributions in excess of $300 per month. Under the tax credit proposal, an employee previously receiving $300 per month tax free would suffer a $720-per-year increase in tax liability (assuming he is in the 40 percent marginal bracket). Nobody should be subjected to a sudden large and disproportionate loss by a change in the tax laws. Usually Congress deals with this kind of problem by including "grandfather clauses" or transition rules. Such provisions would be appropriate in this case. For example, an employee might be allowed to retain an individual limit on tax-subsidized health insurance premiums equal in dollar amount to the employer's contribution in 1983 until the increase in GNP per capita caught up to that amount. Of course, one must acknowledge that, to the extent individuals are protected from increased tax liabilities by transition rules, the initial net budgetary cost of the proposed tax credit will be higher.

One of the purposes of this proposal is to create market conditions more favorable to the growth of cost-effective comprehensive care organizations by making buyers cost conscious in their choice of health plan. Under the present "employer pays all" mode, there is often little or no incentive to make an economical choice. Some leaders of the HMO movement are concerned that the tax-subsidized amount might not keep up with the costs of a comprehensive plan. To see the potential problem, imagine that the subsidized limit were $50 per family per month rather than $150. Some insurers would then offer policies with a $50 monthly premium and a deductible high enough to make that possible. People expecting no medical costs would choose a high deductible. People expecting substantial medical expenses would choose comprehensive plans such as HMOs. HMOs would be destroyed by adverse selection. This is a matter of particular concern to HMOs because the federal HMO Act requires them to cover comprehensive benefits, but does not place similar requirements on other health insurance plans.

One answer to this concern is that tying the limit on the subsidized amount to the growth in GNP per capita should allow for continued real growth. Even so, if health care costs continue to rise much faster than GNP per capita, the medical purchasing power of the subsidized amount could erode. Congress should review the program periodically to prevent excessive erosion. Another safeguard would be the common benefit standard applied to all health care plans qualifying for the subsidy.

HMOs would then be subject to the same rules as their competitors and not forced to offer more comprehensive coverage.

What about administrative expense? Under the tax credit the IRS would see millions of new "H-2 forms." A new line would be added to Form 1040 for a new tax credit in addition to the eight already there. Millions of people who do not now file tax returns would do so in order to receive their refundable tax credit. Employers who do not now allocate health insurance expenses on a per employee basis would have to do so. They would have to allocate on a per individual or family unit basis and by geographic area when there are significant differences. As an accounting problem, this would be no more complex than most. This cost needs to be judged in the context of the problem of rapidly rising health care costs, the gains in efficiency that could be achieved in a more cost-competitive health care economy, and the great complexity of regulatory solutions to health care cost problems. I believe the efficiency gains would far outweigh the costs of administering the tax credit. And I think it is inevitable that the federal government will have to act somehow to bring the growth in its revenue losses associated with tax subsidies to health insurance into line with the GNP.

Finally, some argue that limiting the exclusion is unnecessary because some employers are beginning to add coinsurance and deductibles and otherwise reduce previously granted open-ended entitlements. In the absence of a change in the tax laws, I doubt that this will be a very pronounced trend. Putting in a $250 deductible, for example, is not a very draconian cost-control measure. Other reports indicate strong resistance by unions to any cuts in health benefits.[19] Absent a change in the tax laws, it is hard to see why employers and employees would find it in their interest to agree that the employee pay a greatly increased share of health care costs with net after-tax dollars. In any event, the proposed refundable tax credit also addresses other deficiencies in the present tax treatment of health insurance.

Conclusions

In sum, replacement of today's open-ended exclusion of employer contributions from the taxable incomes of employees with a refundable tax credit equal to 40 percent of each individual or family's premium payments to a qualified health care plan, up to a limit of 40 percent of $60 or $150 in 1983 dollars, would make subsidies for the purchase of health insurance universally available to those who could buy insurance. This would attenuate the adverse risk selection problem that now plagues attempts to cover individuals not in groups. Combined with continuity of coverage requirements for qualified health plans, this would facilitate continued coverage for the unemployed.

At the same time, the tax credit would make buyers cost conscious in their choice of health plan, and thus replace an important cost-increasing incentive with a reward for an economical choice. This would represent a major and favorable change in the health care economy from the point of view of demand for membership in cost-conscious health care plans. And the tax credit would distribute public subsidies for the purchase of health insurance more equally across the income classes and within income groups, as between the employed and others.

The tax credit approach would greatly reduce the "Medicaid notch" —the loss in public subsidy that a Medicaid beneficiary suffers when he or she increases his or her earnings enough to exceed the eligibility limit. The tax credit approach would also bring the growth of the federal revenue loss from tax subsidies to health insurance into line with the growth of the GNP. And the tax credit could be used as a lever for some socially desirable rules for fairer competition among tax-favored health care financing and delivery plans.

NOTES

1. Statement of Robert J. Rubin, M.D., Assistant Secretary for Planning and Evaluation, DHHS, before the Senate Finance Committee, 22 June 1983.
2. Internal Revenue Code, sec. 105 and sec. 106.
3. Paul B. Ginsburg, *Containing Medical Care Costs Through Market Forces*, Congressional Budget Office (May 1982).
4. Amy K. Taylor and Gail R. Wilensky, "The Effect of Tax Policies on Expenditures for Private Health Insurance," in Jack A. Meyer, *Market Reforms In Health Care: Current Issues, New Directions, Strategic Decisions* (Washington, D.C.: American Enterprise Institute, 1983).
5. Health Insurance Association of America, *Source Book of Health Insurance Data* (Washington, D.C.: HIAA, 1982-1983).
6. Amy K. Taylor and Walter R. Lawson, Jr., "Employer and Employee Expenditures for Private Health Insurance," *Data Preview* 7, National Center for Health Services Research, National Health Care Expenditures Study, U.S. DHHS Publication No. (PHS) 81-3297.
7. Maureen Baltay, *Profile of Health Care Coverage: The Haves and Have-Nots* (Washington, D.C.: Congressional Budget Office, March 1979).
8. Ginsburg, in *Containing Medical Care Costs*, estimates that in 1983, the average federal marginal tax rates that would apply to employer contributions if they were taxed was 38 percent.
9. Health Insurance Association of America, *Source Book*.
10. Taylor and Wilensky, "The Effect of Tax Policies."
11. Ginsburg, *Containing Medical Care Costs*.
12. Ginsburg, *Containing Medical Care Costs*.
13. *Health Incentives Reform Act*, 96th Cong., 1st sess., 12 July 1979, S.Rept. 1425.
14. Marjorie Smith Carroll and Ross H. Arnett II, "Private Health Insurance Plans in 1978 and 1979: A Review of Coverage, Enrollment, and Financial Experience," *Health Care Financing Review* 3 (September 1981).
15. *Health Incentives Reform Act*.
16. Personal communication from Amy K. Taylor. Estimates based on the 1977 National Medical Care Expenditure Survey. See Taylor and Wilensky, "The Effect of Tax Policies." Dr. Taylor's preparation of these estimates is gratefully acknowledged.
17. See Taylor and Wilensky, "The Effect of Tax Policies." This calculation excludes the tax revenue loss associated with the exclusion of employer contributions to the health insurance of retired Medicare beneficiaries, estimated conservatively at $900 million.
18. Alain C. Enthoven, *Health Plan: The Only Practical Solution to the Soaring Cost of Medical Care* (Reading, Mass.: Addison Wesley Publishing Company, 1980).
19. "Moves to Cut Health-Care Benefits Meet Stiff Opposition from Unions," *Wall Street Journal*, 26 October 1983.

Statemenc on the Tax Treatment of Fringe Benefits

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Mr. Chairman, my name is Alain C. Enthoven. I am a professor of management at Stanford, with specific interest in the economics and public policy of health care. Over the past 10 years I have written extensively on the problems of cost and inequity in distribution of health care. I have been associated particularly with the idea that we should solve our problems of cost and equity of access through a system of rational incentives and subsidies in a decentralized private market, rather than through centralized government controls. In 1978, I published a proposal for universal health insurance, based on competition in the private sector, called Consumer Choice Health Plan which explained how this could be done. (See the New England Journal of Medicine, March 23 and 30, 1978.) The views I present are of course my own and not necessarily those of Stanford University or any other organization with which I am associated.

Thank you for the priviledge of appearing before this distinguished Committee.

The favorable tax treatment of certain fringe benefits of employment has a rational basis in social policy objectives. For example, through the favorable tax treatment of retirement plans, our society encourages people to save for an economically self-sufficient retirement. This encourages savings which help finance economic growth. And it reduces the burden we place on public programs such as Social Security and Supplemental Security Income. The favorable tax treatment of child care services is intended to reduce the tax-induced inefficiency in the labor market and the tax revenue loss that would be caused by the work disincentive inherent in making a working mother pay for child care out of net-after-tax income. And the tax subsidy to employer-provided health insurance has been an important factor motivating the spread of private health insurance, thus helping to solve an important social problem without the need for direct government action.

Therefore, while acknowledging the great appeal of the flat tax idea, we should give careful consideration to the important social purposes motivating certain provisions of the tax code.

Employer provision has played an important part in the historical development of retirement plans and health insurance. However, rational social policy argues strongly for making the tax subsidies that encourage them independent of employer provision of the benefits. Otherwise we end up denying the tax subsidies to those who need them most: the part-time employed, the intermittently employed, the self-employed, the unemployed, and those employed in marginal industries whose employers cannot afford to do much in terms of fringe benefits.

In the case of retirement plans Congress, in its wisdom, saw fit to extend to the self-employed tax-sheltered retirement savings opportunities similar to those available to the employed. Thus we have Keogh plans and IRAs. And in the interest of protecting the budget from open-ended subsidies to upper income people and of preserving some equity in the distribution of resources, Congress put limits on annual tax-deductible contributions to retirement plans for people, whether provided by their employer or not. Limiting the contributions and extending the opportunities for tax sheltering to the self-employed and others has not led to the destruction of employer-provided retirement plans.

Similarly, I believe that capping exclusions from taxable income of employer-provided health benefits, and extending the benefits of the exclusion to all people, whether or not they have an employer contribution, would not lead to the destruction of employer-provided health insurance. Rather, as in the case of retirement plans, it would protect the Treasury from open-ended subsidies to upper income people, and it would improve the equity of resource distribution.

Congress ought to do for health insurance what it has done for retirement plans: make limited exclusions from taxable income available to all persons.

Mr. Chairman, there are four things seriously wrong with the present tax treatment of health insurance and employer-paid health benefits.

First, the cost to the budget is very large and growing much faster than the GNP. In a memorandum to Senator Durenberger, a copy of which is attached to my statement, I estimate that at 1986 spending levels, the cost to the federal budget of tax-sheltered health insurance premiums will be about $49 billion dollars, assuming 90 percent of employees take full advantage of the opportunity to shelter premiums through cafeteria plans.

This startling number greatly exceeds the estimated revenue loss of $23.7 billion for 1986 in the FY 1986 President's Budget. But that estimate can be reconciled with my estimate by making three corrections. First, lost payroll tax revenue should be included as well as income tax revenue. Second, there has recently been an 18 percent upward revision in the volume of private health insurance estimated by the Health Care Financing Administration. And third, the estimate should reflect the May 1984 IRS clarification of Section 125 cafeteria plans and assume that most people will soon be taking advantage of this opportunity to tax shelter employee premium contributions, as many are doing now.

In addition to the $49 billion, it is quite easy to see how an additional $11 billion could be lost as employees use salary-reduction and forfeitable flexible spending accounts to tax shelter out-of-pocket medical expenses.

Thus, we are facing a revenue loss of at least $60 billion a year.

Moreover, this source of revenue loss is growing much faster than the GNP. In a May 1982 CBO report, Paul Ginsberg estimated that this federal revenue loss increased from $3.2 billion, or 0.34 percent of GNP in FY 1970 to $19.8 billion or 0.7 percent of GNP in FY 1981. In other words, it about doubles its share of GNP in a decade.

The second major defect of the present tax treatment of health insurance is that it is inequitable. It does the most for people who need it the least, and it does nothing for many of the people who need help the most.

The tax subsidies are generous to upper income people who are well insured. Because they have incomes and assets to protect, one can be sure most such people would buy health insurance even if there were no tax subsidies.

On the other hand, the tax subsidies are small or non-existent for many people who need help the most: the part-time employed, the intermittently employed, the self-employed, the unemployed and those employed in marginal industries whose employers do not provide health insurance, and the widows and divorcees who lost their health insurance when they lost their husbands. If these people can get health insurance at all, as well as having to pay for it with higher individual premium rates, they have to pay for it with net-after-tax income. These are people whose decisions whether or not to buy health insurance are influenced by its cost.

If you believe that federal tax policy ought to be used to promote the spread of private health insurance, then these are the people on whom the tax incentives should be targeted.

The same CBO report found that 70 percent of employer contributions went to households with annual incomes over $30,000. About three-quarters of the contributions went to households with incomes above the median.

If the federal budget can afford $60 billion in subsidies to health insurance and flexible spending accounts, then that money ought to be divided up equally among the rich and poor so that everyone receives financial assistance toward the purchase of health insurance, if not preferentially for the poor.

In the Medicaid program we have a formula that pays larger subsidies to states with lower per capita incomes. The purpose is to provide more powerful incentives to poor states to provide decent Medicaid benefits.

In the Tax Code we have a formula that provides larger subsidies to people with higher incomes. For example, CBO found that in 1983 the tax break for employer health benefit plans was worth $622 per household in the $50,000 - $100,000 income range and was worth $83 per household in the $10,000 - $15,000 range.

The third thing wrong with the present tax treatment of health insurance is that it reinforces the cost-increasing incentives in the health care financing and delivery system. It induces employment groups to buy cost unconscious open-ended comprehensive insurance. It tells upper income groups that if they decide on still more costly benefits, government will pay 40 to 50 percent of the extra cost.

The present tax treatment of health insurance has been the main cause of the paradoxical situation that millions of people are overinsured and causing inflation in health care, while millions of other people are underinsured or have no coverage at all.

The irony and irrationality of this is compounded by the fact that through the open-ended tax subsidy, the government is subsidizing the efforts of upper income people to bid up the prices and standards of care that the uninsured must then pay for directly and that the government must then pay for through Medicare and Medicaid. Government is subsidizing its own competition.

The rational tax reform I recommend would help correct both failures. It would give everybody incentives and help to buy insurance up to the price of a good quality cost-effective health plan, and it would make everybody fully cost conscious above that level.

The fourth major defect of the present tax treatment is that it reinforces the link between jobs and health insurance. People lose their health insurance when they lose their jobs, arguably when they need it most. This link to jobs adds greatly to the complexity of the problem of getting everyone insured.

Pamela Farley found that of the under-65 population in 1977, 9 percent went all year with no public or private health care coverage, and another 9.4 percent were covered only part of the year. There is no reason to think the situation has improved markedly since then. The civilian unemployment rate is a little higher now than then. The percent of families below the poverty line has increased. In terms of today's population, these percentages would mean about 19 million people are uncovered all year and 19.7 million are uncovered part of the year.

It used to be that many of these people received care free from community hospitals when they became seriously ill and couldn't pay. The hospitals simply passed on the costs to cost-unconscious third party payors. But now cost-conscious competitive medical plans and Medicare's Prospective Payment System are rapidly replacing traditional cost unconscious insurance. And hospitals are finding they have nobody to whom to send the bills for so-called "uncompensated care." Thus, competition, which is doing a great deal to solve the problem of cost growth is exacerbating the problem of financing care for the uninsured, and it is becoming more urgent than ever that we take decisive steps toward universal health insurance. If we don't, the strategy of competition will be found to produce socially unacceptable results, and society will turn toward regulatory solutions as has happened in several states already.

Mr. Chairman, surely the social policy goal of tax subsidies to health insurance should be to motivate and help everyone, whether employed or not, purchase a good quality comprehensive cost-effective health plan, and to discourage people from purchasing an inefficient overly costly health plan.

And the way to do this is to subsidize everyone's purchase of a health plan up to a limit judged to correspond to the price of a good quality cost-effective plan, and not to subsidize choices above that limit.

This is not a radical new idea in 1985. Important steps in this direction have been embodied in legislative proposals by some of the most distinguished and thoughtful members of Congress for at least the past six years.

In July 1979, Senator Durenberger, now Chairman of the Senate Finance Health Subcommittee introduced the Health Incentives Reform Act of 1979 which would have, among other things, limited tax-free employer contributions to the average HMO premium. That bill was co-sponsored by Senators Boren, Boschwitz and Heinz. Subsequent versions of that bill set a specific dollar limit, indexed to inflation.

Also in 1979, Mr. Ullman, Chairman of the Ways and Means Committee introduced the Health Cost Restraint Act of 1979, which would have, among other things limited tax-free employer contributions to $120 per family per month, indexed to the Consumer Price Index.

In June 1980, Mr. Jones, subsequently Chairman of the House Budget Committee introduced the Consumer Health Expenses Control Act which would have, among other things, limited tax-free employer contributions to $100 per family.

In March of 1983, Senator Dole, then Chairman of this Committee, introduced his Health Cost Containment Tax Act of 1983 with a 1984 limit on tax-free employer contributions of $70 per month for individual coverage and $175 per month for family coverage, again indexed to the Consumer Price Index. This approach was supported for several years by the Reagan Administration and was included in the Treasury's first tax reform proposal in December 1984.

These tax cap proposals would have saved the budget billions of dollars and would have greatly improved the economic rationality of the financial incentives in the health care system. But, by themselves they would have done nothing for the self-employed and others without tax-free employer contributions. This year Senator Durenberger introduced S.1211, the Health Equity and Fairness Act of 1985, which contained some very substantial improvements over previous tax cap proposals. While this bill put a limit on tax-free employer contributions of $100 per month for individual coverage and $250 per month for family coverage, indexed to the GNP deflator, it extended the same deduction to individuals, so that, for example, the self-employed could receive the same tax incentive to insure. In addition, this bill includes important continuity of coverage provisions including a requirement that individuals who lose eligibility for coverage under an employer plan will have the right to continue the same coverage at their own expense for at least a year at a premium not to exceed 110 percent of the applicable group rate. These provisions would be of great help to many of the 19.7 million who go part of the year uncovered but wish to remain insured.

As I pointed out earlier, the people who need the most incentive and help with the purchase of health insurance are those with low incomes. People with high incomes have incentives to insure because they have incomes and assets to protect. The trouble with the deduction or exclusion approach is that it is worth more to people in higher tax brackets, little to people in low brackets.

Therefore, I would recommend that the Congress go beyond the approach of these bills and create a refundable tax credit or direct subsidy to qualified health plans equal, for example, to 40 percent of premium payments up to a limit on subsidized premiums of $60 per month for an individual, $120 for a couple, and $180 for a family in 1986, indexed to GNP per capita. Such a credit would be equally valuable to a person with a low-income as to a person with a high income. It would give everyone an incentive to buy a health plan up to the subsidized limit, but would make them fully cost conscious above that limit. (The credit would replace the exclusion).

Such a subsidy could be of considerable assistance to state and local governments in their efforts to arrange insurance for the uninsured.

Excluding Medicare and Medicaid beneficiaries who are subsidized separately, these credits, if fully used, would cost the budget about $47 billion in 1986. Over the long run their cost wold grow with the GNP, not faster. And the cost consciousness this restructuring would foster would ease the problems of cost growth in Medicare and Medicaid.

This reform would represent a long step toward universal health insurance. Additional steps to make subsidized insurance available to low income people would be needed, but this could be done in the context of a competitive, economically rational, and decentralized private market.

While I have outlined a series of bills and proposals that would take us in the direction of equity and rational economic incentives, politics appears to have led the Reagan Administration in the direction of a proposal that is inequitable and does nothing to reform incentives. I am referring to the recent proposal to tax the *first* $10 per month of individual coverage and $25 per month of family coverage. Not only would this do nothing for the uninsured, self-employed, unemployed, and others who need help, but the burden of this proposal would fall most heavily on the most modest plans. This proposal is regressive. It is as if, on a larger scale, someone proposed to tax only the *first* $10,000 of individual income and $25,000 of family income. This proposal would make things worse. It is not worthy of your support.

Mr. Chairman, I have recently written an article on the tax treatment of health insurance. It explains many of these ideas in greater detail. With your kind permission I would like to submit it for inclusion in the record of this hearing.

This concludes my prepared remarks.

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ALAIN C. ENTHOVEN
MARRINER S. ECCLES PROFESSOR
OF PUBLIC AND PRIVATE MANAGEMENT

August 28, 1985

The Honorable Bob Packwood
United States Senate
259 Russell Senate Office Building
Washington, D.C. 20510

Dear Senator Packwood:

I have received a copy of a letter to you from William O. Bailey, President of Aetna Life and Casualty Company, concerning our testimony before the Senate Finance Committee on July 19, 1985. This is a comment on his letter.

With all due respect, I think most of Mr. Bailey's letter misses the point. The issue at the hearing was not the overall progressivity of the tax code, or whether an alternative hypothesized by Mr. Bailey would be more or less progressive. The issue was tax treatment of employer contributions to health insurance.

Mr. Bailey correctly records our agreement on "the importance of tax incentives in ensuring widespread medical care coverage...if given a choice between wages and taxable benefits, young or healthier and lower paid employees would more often than not choose cash...this leads to problems of adverse selection, raising the cost for all those who remain in the plan...a blend of sound tax and social policy should avoid this result." But he does not draw the logical conclusion.

From exactly this point of view, the trouble with the present tax treatment of health insurance is that it gives the greatest incentives to those who need them the least, the least incentives to those who need them the most.

The present system provides generous subsidies to upper income people who have a regular employer who provides health benefits. That is where about three-quarters of the tax-free dollars go. (A still higher proportion of the tax savings go to such people because they are in higher tax brackets.) The present system provides little or no subsidy or incentive to those who need them most: the part-time employed, the intermittently employed, the self-employed, the unemployed and those employed in marginal industries whose employers cannot afford to provide much in fringe benefits, and the widows and divorcees who lost their health insurance when they lost their husbands.

We agree that the justification in social policy for such tax incentives is to promote widespread medical care coverage. But upper income people with a regular employer don't need much incentive. Because they have incomes and assets to protect, one can be sure most of them would buy medical coverage even if there were no tax incentives. The people who need the help and encouragement are the part-time employed, the intermittently employed, the unemployed, and low income people generally. These are the people among whom the lack of coverage is concentrated. For example, the National Health Care Expenditures Study found that about 54 percent of people in households headed by a part-time employed female had no private coverage, and 22 percent had no public or private coverage.

The point of the discussion of the distribution of tax incentives by income classes is that the present system is not rationally designed to promote widespread coverage. It targets the incentive in the wrong place. A refundable tax credit, equally available to rich and poor, would distribute the incentive more equitably.

On the other hand, Mr. Bailey offers no evidence that a generous limit on the amount of tax-subsidized premiums, such as $180 per family per month, would reduce the number of people covered. I believe there is no evidence to support that. What such a limit would do is to promote cost-consciousness in choice of health plan among well-covered people.

I would appreciate it if you would include my letter in the hearing record. (As I said at the hearing, these views are my own and not necessarily those of any organization with which I am associated.)

Yours sincerely,

Alain Enthoven

Alain Enthoven

AE/ks

cc: Mr. William O. Bailey
Senator Bill Bradley
Senator Dave Durenberger
Mr. Dallas Salisbury

STATEMENT BY DR. JOHN L. BOMBA, PRESIDENT, AMERICAN DENTAL ASSOCIATION, WASHINGTON, DC

Dr. BOMBA. Thank you, Mr. Chairman and members of the committee.

I am Dr. John L. Bomba of Philadelphia, PA, and this year have the privilege of serving as president of the American Dental Asssociation, which represents 140,000 members.

The CHAIRMAN. I would like to welcome Dr. Bomba back here again.

Dr. BOMBA. I am pleased to be here. In these days, one is pleased to be anywhere. [Laughter.]

The CHAIRMAN. You don't mean other than Philadelphia?

[Laughter.]

Senator BRADLEY. On that high note, I am interested in his testimony. [Laughter.]

Dr. BOMBA. I want to thank all of you for the opportunity to appear. I am pleased that you are going to place our testimony in the record. Consequently, I am going to briefly summarize what I think are the highlights of that prepared testimony.

First of all, the association wishes to commend the chairman for his vigorous leadership in opposing taxation of employee benefits and health benefits in particular, and for your understanding of the basic issue. We know that your efforts played a significant role in causing the administration to abandon its original proposal, and for that we are very thankful. We are unalterably opposed, as an association, to the tax cap and urge all of you, in considering the entire proposal, remember that there are significant differences in the delivery of dental care as opposed to health care in general.

We believe that, should a tax cap be enacted, it would have serious adverse effects on the health of the American people.

The revised proposal, on the other hand, is a positive improvement. We do have a continuing concern, however, that should some traditional patterns be followed, and the revenue need to be increased over a long period of time, the same adverse effects that we spoke of would occur; it would just take a longer time for that to appear.

We think that it is unfortunate, and that it would be an error, to focus on tax revenues alone when one considers health benefits. We need to take into consideration the traditional social concerns about making health care accessible to all Americans.

We believe, too, that health care ought to remain in the private sector. The current provisions of the tax law have made it possible for us, in dental insurance for example, to have the number of people covered grow from only 6 million in 1968 to 105 million today. Changes in that current tax structure would cause that situation to be reversed.

Our testimony, in a way, reviews the growth and effectiveness of dental prepayment. We talk about the beneficial aspects of including in the design of dental programs emphasis on prevention and cost-saving mechanisms such as copayments and deductibles.

We are also proud that because of those provisions, dental costs have not accompanied the high rates of inflation such as have accompanied other health care costs.

Our basic thrust, then, is that the current tax provisions are working, that the vast majority of workers are protected against the high cost of illness. We believe that the current proposal is better than the one that came before it, but we still have some concerns about it. We are concerned that fairness and simplicity don't always go hand-inhand, and that sometimes a degree of complexity is necessary to accomplish the result.

Some other witnesses this morning have also indicated their support for broadening the base of health coverage and making such coverage available to those Americans who currently don't get the same kind of a tax treatment.

We thank you again for holding the hearing and will attempt to answer any questions that members of the panel may have.

Thank you very much.

[Dr. Bomba's written testimony follows:]

ADA American Dental Association

STATEMENT ON

TAXATION OF EMPLOYEE BENEFITS

BEFORE

THE COMMITTEE ON FINANCE

UNITED STATES SENATE

July 19, 1985

WASHINGTON OFFICE 1111 14TH STREET, N.W. WASHINGTON, D.C. 20005 202/898-2400

Mr. Chairman, Members of the Committee, I am Dr. John L. Bomba of Philadelphia, Pennsylvania. This year I have the privilege of serving as President of the American Dental Association which represents 140,000 members. We thank you for this opportunity to appear before you today.

At the outset, I wish to thank and commend you, Mr. Chairman, for your understanding of the basic issue and your vigorous leadership in opposition to the tax on health benefits as proposed by the Administration during the last Congress and as contained in the Treasury I tax reform proposal. Your efforts clearly have played the most significant role in convincing the Administration to abandon that original approach which we believe would have serious adverse effects upon the health of the American people.

As we will outline in our comments, the revised Administration proposal, if left unchanged, would not have the negative consequences of the so-called tax cap. In fact, it is a very positive improvement. As I am sure you can appreciate, however, our concern is that, over time, the level of the proposed tax floor will not remain unchanged. As more revenues are sought, larger amounts of employer contributions are likely to be taxed and may lead ultimately to the serious consequences we are seeking to avoid.

The American Dental Association objects strongly to an orientation toward the provision of employer sponsored health benefits which is based simply on tax revenue considerations. We think it is critically important that the Congress keep in mind the historical, and still valid, social and health goals which are accomplished through the exemption of these expenditures from tax consequences.

The fundamental consideration which must be taken into account throughout the debate on possible taxation of health benefits is that the current tax laws encourage the vast majority of Americans to obtain the health protection of their choice through the workplace. We do not believe that this continually improving private sector health care delivery system can be maintained if billions of supporting dollars are withdrawn. In our opinion, the withdrawal of the support and incentives provided by current tax law would reverse the progress that has been made in private sector health insurance coverage and lead to renewal of public pressure for greatly expanded government programs at much greater cost, lower efficiency and with regulatory mechanisms that could adversely affect the quality, selection and availability of health services.

The current tax laws have proven beneficial in improving access to dental care and thereby improving the oral health of the public. Currently more than 105 million Americans receive employer sponsored dental benefits. Studies show that people covered by these plans are motivated to receive more preventive care than those who are not covered. This results in better dental health and cost savings over their lifetimes. If a new tax system provided incentives for employees to drop dental benefits, as some of the proposals before you would, alternative coverages would not be available since dental benefits must be offered on a group rather than an individual or family basis.

The growth in the number of people covered under dental benefit plans from approximately 6 million in 1968 to 105 million today has not been accompanied by the high rates of inflation that have characterized costs of many other health services. We believe a major factor in keeping increases in dental fees approximately equal to the overall increases in the Consumer Price Index is that dental benefit plans uniformly require beneficiary participation through copayments and other cost-sharing mechanisms.

It also should be pointed out that dental benefit plans make dental services available to many low income employees. This contrasts with the Medicare and Medicaid programs, which are almost totally deficient with regard to dental benefits.
Finally it must be stressed that better dental health results in higher employee productivity and consequent economic benefit to industry, both large and small.

Given the benefits of the existing system, we briefly would like to comment on the consequences of the proposed changes in the tax treatment of these benefits.

The Administration's current proposal would require all employees to include part of their employer's health benefit contributions in their taxable income. Single employees would be required to add $10 a month to their taxable income while those with family coverage would add $25 a month.

On the face of it these numbers seem relatively small and may not impose much burden on most Americans. We feel, however, that even at these levels, the tax could, in certain situations, cause some employees to reduce or drop their health benefit coverages ages because of the additional costs involved.

As I mentioned earlier it also is predictable that over time there will be pressure to increase the taxable amounts to raise additional revenues. One need only cite the example of the threshold for individual taxpayer deduction of medical-dental expenses, which went from 1 percent of gross income to 3 then 5 percent and would be increased to 10 percent under other pending tax legislation. With each increase in the amount of health benefits subjected to taxation under the "floor" proposed by the Administration, there would be further disincentives for some individuals to receive adequate protection.

Much more objectionable are the proposals to initially tax employees for that part of their employer's contribution above specified amounts, or all of their employer's contributions. In the case of this former type of proposal, it can be predicted that the "cap" eventually would be lowered to zero. The proposals to tax all of the employer's contribution provide very significant incentives for individuals at all income levels to underinsure. This would only dramatically escalate the numbers who might have to rely on government programs for their health care.

Proposals to tax employer contributions above certain stated amounts provide the wrong solutions to some very significant problems. The major result of such an approach would be to assure that employees demand that their employer's contributions remain below the tax free limit. For dentistry, studies have shown that a large proportion of employees will be induced to forego cost effective, prevention oriented dental benefits in order to avoid tax consequences. This change would accomplish little, while jeopardizing the oral health of the American people. As the tax free limit is decreased more and more benefits will be dropped with more and more people vulnerable to major health expenditures. We believe this will lead to a need for greater government involvement in meeting the health needs of these individuals, and will only increase the costs of health care.

We simply must reiterate that the entire approach of placing taxes on health benefit contributions is counterproductive to all that has been gained in developing the private sector health insurance system as we know it. We acknowledge that further improvements must be made in that system. However, we should attempt to make those improvements rather than hinder their development.

There is a related area where change is important. As we have noted, employees are not taxed on their employer's contributions for health benefits. That policy is proper and should remain. At the same time, self-employed individuals who contribute to their own health insurance protection must pay for that protection with after tax dollars. We feel it is a matter of equity that self-employed individuals be treated in the same manner as employees and at least be permitted to deduct or receive tax credits for payments for their health protection. Legislation has been introduced in both the House and Senate to address this issue. We urge you to recommend that these small businessmen and women be aided, as are employed individuals, in their efforts to obtain needed health insurance protection.

Again Mr. Chairman we commend you for holding these extremely important hearings. I would be pleased to attempt to answer any questions you may have.

The CHAIRMAN. For all of the arguments you can make for or against the taxation of employees benefits, it is not a step toward simplicity. The present system is relatively simple: the employer contracts or an agreement with the union contracts pays the insurance company, they are not taxable as income, the employee collects the benefits. You start counting part of it as income, and you have withholding problems, you have filing problems; it is a step toward complexity, not simplicity. It is a different argument than fairness, and I am prepared to argue it is unwise and unfair to boot, but it certainly is not a move towards simplicity.

Senator Durenberger.

Senator DURENBERGER. In a move toward simplicity?

The CHAIRMAN. Not a move toward simplicity. [Laughter.]

Senator DURENBERGER. Mr. Bailey, I think you were here before when I asked Mr. Sardegna some questions about the health care cost to an average 30-year-old male in Portland, OR. Do you argue with the premise that income levels really have nothing to do with how much it costs? I mean, the wage or income levels don't really have anything to do with the cost of taking out an appendix or curing pneumonia, and that it really is age, sex, the previous health condition?

Mr. BAILEY. Far greater influences are the average age of the population or the employee popluation; geography plays an important consideration in the context of average health care values, far more important than income, sir.

Senator DURENBERGER. OK.

Do you know what Aetna is contributing per year, on the average, to its employees?

Mr. BAILEY. Yes; our present contribution runs $600 per individual, and approximately $1,800 for family coverage.

Senator DURENBERGER. So it is $1,800 a year for family coverage?

Mr. BAILEY. Yes, sir.

Senator DURENBERGER. OK. There is a CBO study in 1983 that indicates that the tax subsidy for people in the $10,000 to $15,000 income bracket across the country, per household, is $83 per household. And in the $50,000 to $100,000 bracket it is $622 per household. Now, that would indicate to me, and I am asking what it might mean to you—it would indicate to me that in America we have set up a health insurance reimbursement through the tax subsidy system that is based on income. It is not based on age, sex, previous health condition, or the average community cost of health care. It is based on income. The richer you are, or the more income you earn, or the larger company you work for, or some other factor, seems to play a role in the amount of tax subsidy.

Mr. BAILEY. My suspicion, Senator Durenberger, is that is a suspicious kind of comparison. I accept, as one might well conclude, that in higher-cost areas, including higher health-care cost areas, people tend to make more money than they do in lower-cost areas.

Senator DURENBERGER. But how would you account for the difference between $83 in the $15,000 a year bracket and $622 in the $50,000 to $100,000 bracket, unless those people were getting more health insurance?

Mr. BAILEY. They may very well be getting more health care, because they are older. I would suspect the average income grows with age. As I said, I think incomes are higher in high-cost areas around the United States than they are in lowest-cost areas; so there is a correlation around other considerations. But to say there is no greater benefit——

Senator DURENBERGER. OK. Well, I haven't read that one recently. I thought that talked about the premium subsidy; I thought that is what that report dealt with, the amount of the premium subsidy.

As you view fairness and simplicity, let me ask you the same question I asked Mr. Sardegna: Is there enough money to go around in this country so that we ought to subsidize Lee Iaccocca on top of his $5 million salary with a $3,300 tax subsidy, while your employees only get a fraction of an $1800 subsidy, and 32 million people get nothing? Just generally, what do you think of that?

Mr. BAILEY. I have some vague familiarity with the Chrysler health insurance program, although not as much as perhaps I would like when you get through questioning me. [Laughter.]

But to a substantial extent, that cost figure is taking Chrysler's total cost of health insurance for all of their active employees, including Mr. Iacocca, and their retirees, and dividing it by their number of employees.

Senator DURENBERGER. Well, I have been through this. It is $6,000 when you factor in their retirees. We subsidize Chrysler and their retirees $6,000.

Mr. BAILEY. Right.

Senator DURENBERGER. It is their active employees like Mr. Iaccocca that we only subsidize $3,300. What do you think, as a citizen, of that kind of system?

Mr. BAILEY. The benefit plan that Chrysler has, and the costs where they are located, produced those kinds of average cost-per-employee. If one were not to provide those kinds of benefits, the real underlying question is, would those costs be significantly different? Does it really make a lot of difference who pays the bill after the fact, or do we, as we clearly believe—you have to get up front in trying to involve health care coverage.

Senator DURENBERGER. Do you have any employees in Detroit?

Mr. BAILEY. Yes; we do have employees in Detroit, a small percentage.

Senator DURENBERGER. Do they buy $300 a year worth of health insurance?

Mr. BAILEY. I can't answer that question. I suspect that their average cost-per-employee is higher than our national average cost-per-employee.

Senator DURENBERGER. I am out of time.

The CHAIRMAN. Senator Heinz?

Senator HEINZ. Mr. Chairman, thank you.

Dr. Enthoven, I noted your citation in my earlier remarks, for which I am grateful. I note we do share the same observation, but I suspect we come to a slightly different conclusion.

Essentially, you argue that the tax subsidy for health benefits is inequitable. I suppose I might say I don't think we do the very best we should be doing with it. And it is true that the system is inequitable for the millions of workers who aren't covered; but the system we have does cover a tremendous proportion of the population right now, many of whom, I might add, if they were here wouldn't agree with you.

Isn't your proposal, if I understand it correctly, which is to make people pay for their own health benefits and then provide for a tax subsidy for the others who don't have any benefits right now, an awfully disruptive way to deal with this inequity? Wouldn't it make a good deal more sense to develop an effective tax subsidy for the people who aren't covered and leave those who are covered alone?

Dr. **Enthoven**. No, Senator, I don't think it would be disruptive at all; I think it would in fact be very, very simple. You would just have a simple formula on the tax form that would say, "You get a tax subsidy up to this limit." The employer would report the employer's contribution, and that would go into your W-2, and then you would subtract out the allowable amount of subsidized insurance.

Senator **Heinz**. I didn't say your proposal would be complicated; I asked whether it would be disruptive.

Dr. **Enthoven**. No, I don't think it would be disruptive, because I think where the cap ought to be set is at the full price of a good quality, cost-effective health plan. So the millions of people who have health plans below that level essentially wouldn't notice it at all. This would be the case, if you used Senator Durenberger's bill or that kind of an approach. Those people above that level would be made cost-conscious for the first time. So there would be a certain amount of change in behavior. People who now have overly-costly open-ended cost-unconscious insurance that is above that limit would have to pay for it with their own net after-tax income, and that would cause them to be cost-conscious. They would say, "Well, now I think I had better consider some cost-effective health maintenance organization or some other plan." So it would change behavior, and that is the intent, to make upper income people cost-conscious and at the same time to turn those savings over to lower income people who are now getting little or no help.

Senator **Heinz**. All right, thank you very much.

The **Chairman**. You are done?

Senator **Heinz**. Yes.

The **Chairman**. Senator Bradley.

Senator **Bradley**. Let me thank the panel for the testimony. Just to undeline the point that Dr. Enthoven made in his testimony, I want to corroborate that the CBO report found that 70 percent of employer contributions went to households with annual incomes over $30,000.

Dr. **Enthoven**. That is right.

Senator **Bradley**. And, also, that the CBO found in 1983 that the tax break for employer health benefit plans was worth $622 for households with a $50-100,000 income range, and $83 per household in the $10-15,000 range?

Dr. **Enthoven**. Right. That is correct, Senator.

Senator **Bradley**. From your knowledge, are those correct figures, Mr. Bailey?

Mr. **Bailey**. I have no knowledge of that, Senator Bradley.

Senator **Bradley**. From your knowledge of the industry, would you say that is correct?

Mr. **Bailey**. Directionally, correct. I would remind you that these are household numbers, not per individual. Households tend to have larger incomes than single people. I have noted in our own case that employer cost is $600 per individual and three times that for a family.

Senator **Bradley**. You mean, you don't think that an individual who lives in a house is a household?

Mr. **Bailey**. Yes; an individual who lives alone is a household as well as a family.

Senator **Bradley**. But you don't dispute the numbers here?

Mr. **Bailey**. No, I don't dispute the numbers, as such.

Senator **Bradley**. I think that overwhelmingly establishes that the bulk of this subsidy goes to upper-income individuals.

Dr. **Enthoven**. Senator, if I could be permitted to give a "homey" example that is going on in my own family, while I am getting, as you are, substantial tax-free employer-provided health benefits, my daughter who is now an unemployed school teacher pays her own Kaiser dues out of her net after-tax income. And for a while this year, she was a part-time school teacher this year, and the school district was therefore paying about 20 percent along, one of my first reactions was, "Well, what they are going to do is wipe out her tax break and barely nibble at mine." Somehow it just seems to be out of whack.

Senator **Bradley**. Do all of you agree that the President's proposal on taxing fringes has, at a minimum, got it backward?

Senator **Durenberger**. Yes.

Mr. **Salisbury**. Senator, I would say it has it backwards; but if I might take the liberty——

Senator **Bradley**. OK. That's all I wanted to know.

Mr. **Salisbury**. I do not disagree with the numbers you are using. I should know.

Senator **Bradley**. Mr. Bailey.

Mr. **Bailey**. It seems to me that, with such an overwhelming percentage of people receiving both the benefit and proposed now to receive the benefit of a lower tax rate, we are taking out of one hand and putting it right back into the same hand.

Senator **Bradley**. OK. Well, that leads to my next question.

The argument has been made here time and time again that, if we don't have the present tax subsidy for employer-paid health insurance, that the only option is a national health insurance program administered by the Federal Government. I'm inclined to think that that is a false dichotomy.

Let me ask you this: If you had a tax-reform proposal that cut the rates low enough so that even though the health insurance premium was included in income, the individual still got a tax break, and in many cases paid less tax, how would that effect whether he had insurance or not? Wouldn't you simply have a situation where the employer would continue to offer the same or maybe even a variety of plans, since now the individual would have to pay for the insurance, and the individual would simply opt for whatever plan was most suitable and that the lower rate of tax would mean less tax paid plus the same health coverage? Why wouldn't that happen?

Mr. SALISBURY. It would happen. You could argue hypothetically that that would happen, assuming that under no circumstances could any individual accept cash in lieu of health insurance.

If, on the other hand—and it is why I simply note that your figures have to be taken into perspective—$3,300, to take a number used for the autoworker, for the autoworker making $20,000, $3,300 as a health insurance premium is a very hefty percentage increase in income. For Lee Iaccocca at $5 million a year, he could take it or leave it "and thank you very much," as a percentage of income.

So, if you did not allow the option of the individual taking cash in lieu of insurance, then it probably would not have a noncoverage effect. If, on the other hand, you allowed the option for a lower income person, at $12,000, "I can take $1,800 or $600 or $3,300 as additional income instead of taking health insurance," our research indicates, and it has not been contradicted by any Government research, that in the first year alone about 10 million individuals would choose the money instead of the insurance.

Senator BRADLEY. Do other people agree, or disagree, on this point, or could you add anything?

Mr. BAILEY. I agree with that point.

Dr. BOMBA. Our concern continues to be that, given a choice, given an option, that would be a sufficient disincentive for many people to drop the insurance. We think if we are going to correct the inequity, it ought to be corrected by extending that same opportunity to the rest of the population and not depriving those who already have it.

Dr. ENTHOVEN. Senator, I think something has gotten a little backwards here. Upper income people have incomes and assets to protect, and you can be sure they are going to buy insurance because they don't want to be wiped out. It is lower income people that need the help. With the tax cap, that would affect the well-to-do, fully insured upper income people. The tax system is now not helping the lower income people.

So what I am saying is, we need to get this thing turned around, at least to the point of equality. Tax subsidies to health insurance have to be "use-it or lose-it" subsidies to induce lower income people to insure.

Senator BRADLEY. Could I just make one last point, Mr. Chairman?

The CHAIRMAN. Yes.

Senator BRADLEY. Essentially what you are saying, Mr. Salisbury, and you agreed, Mr. Bailey, is that people who would have the means to buy the health insurance would choose to take the cash and not buy the health insurance, if they had that choice.

Mr. SALISBURY. No. I am saying that people who do not have the means—I am agreeing totally with Dr. Enthoven's last comment. Use it or lose it would be absolutely crucial to making the concept work. In the absence of use it or lose it, it is the low-income individual who would not choose to allocate 20 to 30 percent of their income, in many cases, to buy health insurance for their family if they couldn't otherwise afford it.

Senator BRADLEY. It strikes me that if this person is in a 25-percent tax bracket now, and he is under a 14-percent tax bracket under reform, or a 15-percent, he would have the means.

Mr. **Salisbury**. I am suggesting, for the low income individual, the means is no the issue. If it were the issue, then you would not have—literally, as Dr. Enthoven noted—several million individuals in this country who earn $20,000 to $25,000 a year and who choose not to buy health insurance when their employer doesn't provide it. If the means was enough to make it happen, those people would all have coverage.

The **Chairman**. Let the record show here that the AFL–CIO, who is notably regarded as representing those who make above $30,000 at the expense of those who make below, are adamently opposed to either a tax cap or a tax floor, and they feel as strongly about this issue as any that I have seen since the issue of labor law reform 6 or 7 years ago. So, maybe they have different economists, or maybe they have a different subjective view; but they feel very passionately that the present system adequately benefits their members, most of whom make under $30,000 a year.

Mr. Bailey, let me ask you this question. You hear this argument: "Oh, who cares about cost containment? You know? It doesn't cost anything to the employees, whatever this is. Just tack it on. The employers don't care; they just tack it on to the price. The Government is picking up the bulk of it. Who cares about cost containment?" What is wrong with that statement?

Mr. **Bailey**. We have found very dramatically in the last 2 to 3 years that both the employees and the employers care a great deal about cost containment. There has been competition introduced into the business of health care, to a degree unprecedented, in the past; plan design programs to encourage second opinions and preadmission qualifications have been developed in order to control costs and preserve the quality of care at the same time; larger deductibles and copays have been introduced by employers who have recognized that the cost of health care was a major ingredient in their overall costs and negative to their ability to compete both within this country and around the world.

And so we have seen a very dramatic change in attitudes towards health care cost containment within the private sector.

The **Chairman**. Why has it happened just in the last 2 or 3 years? Employers, by and large, were always concerned about costs. Why all of a sudden health costs in just the last 2 or 3 years?

Mr. **Bailey**. Well, health care costs over the last 5 years have risen substantially more rapidly than the overall CPI has, and that has attracted attention. Government, through various cost-shifting mechanisms, has added to that burden on the private sector, and we have become, as a nation, far more competetively conscious than we have before, and people I think are looking more carefully at costs than was true a half-dozen years ago, to our total benefit.

The **Chairman**. Dr. Bomba, let me ask you this. I used to be a labor lawyer in bargaining plans, and it was always my experience that it was the most expensive kind of coverage that came in last—the psychiatric, dental, eteglasses. If we have a tax cap, and if employers try to stay under that cap, do you expect that dental coverage might be one of the first coverages to go?

Dr. **Bomba**. I think that's been demonstrated and proven in some studies. The study that Senator Bradley just referred to by the Congressional Budget Office shows that that would be likely to happen, it shows that utilization would be seriously affected. So there is no question in our minds that, should that choice occur, that the last on would be the first out, and that dental benefits would be likely targets to be dropped.

I would just like to add to what Mr. Bailey said a minute ago about the current climate in negotiating for fringe benefits or health care benefits, or employee benefits in general. Where we went through a period of time in our economy where employers were more likely to concede to demands of negotiators, that era is gone, and in a competitive climate we are seeing significant chages in the willingness to escalate those costs.

So we think we would hate to see a regressive action take place by changing the current tax code. We think that the worst remedy for inequity is to seek the least common denominator, and that might be indeed the scenario that would occur.

The CHAIRMAN. Let me ask you, Mr. Bailey, if you have seen this, because I think I have: You have a lot of competitors in this business for carriers, and they are willing to go in to those that you are providing coverage for and say, "Listen, when your contract with Aetna runs out, let us tell what we will do for you for the same price or for $5 a month less." Is that true?

Mr. BAILEY. That is true.

The CHAIRMAN. And you have to be on your toes perpetually to watch out for all of these other companies who are trying to do you in.

Mr. BAILEY. We work very hard, I think as do many other companies in our business, at cost containment, increasingly recognizing the fact that you have to get ahead of the provision of services in that effort rather than to try to deal with the costs once they been incurred.

The CHAIRMAN. Senator Long?

Senator LONG. No questions at the moment, Mr. Chairman.

The CHAIRMAN. Senator Bradley.

Senator BRADLEY. Thank you, Mr. Chairman.

I would like to come back, if I could, to Dr. Enthoven and Mr. Salisbury, because I don't quite understand at least what Mr. Salisbury has said. Correct me.

Dr. Enthoven says we need a refundable tax credit because people with low incomes just don't have any health coverage at all. He also says that many lower middle income people are not now covered. Those are two facts.

And yet, when we suggest that we include health insurance premiums in income, the argument is, 'Oh, well then those low- and middle-income people who would have more money in their pockets because the lower rate of tax & the bigger exemptions and standard deduction would opt out and choose not to have the health coverage.

According to your own testimony, they don't have health coverage now, most of them.

Mr. SALISBURY. No, that is not the case. Right now, 67 percent of those people who file tax returns have health insurance coverage.

Senator BRADLEY. What about the income level? What percent of the people are earning under $20,000?

Mr. **Salisbury**. Of those with health insurance, if you take the cuts—and I will submit for the record a table that shows it by income level—the level we cut it out was $25,000 per year. And of all individuals with health insurance, 76 percent of them earned less than $25,000 per year in 1983. That is Census Bureau data and Internal Revenue Service data. That indicates the vast, vast majority.

In 1982 the Treasury Department did, for the Joint Economic Committee, a study——

Senator **Bradley**. What was that number—75 percent?

Mr. **Salisbury**. Seventy-six percent.

Senator **Bradley**. Under $25,000?

Mr. **Salisbury**. $25,000.

Senator **Bradley**. And at an average value of what, per household?

Mr. **Salisbury**. Well, the benefit is basically common, so if you take the numbers AETNA used, $600 in purchase value for the individual or $1,800 per family.

Senator **Bradley**. And the CBO says $83 per household. What is the difference?

Mr. **Salisbury**. What CBO is saying is not the value of the insurance if they had to go buy it; they are saying if they bought it and they took a deduction on schedule A, how much would their taxes be reduced as a result of having purchased health insurance? And the lower income person's taxes would be reduced—the subsidy, if you will—by I believe it is $82, and for the higher income individual, on average, by $622. That means, based on the CBO analysis, if they added in a component which said we are going to go to a flat tax, and 15 percent will be the tax rate for everyone regardless of the income level, then CBO——

Senator **Bradley**. Nobody is suggesting that.

Mr. **Salisbury**. I am using a hypothetical. CBO's numbers would have been identical for every taxpayer in the United States.

So, the more progressive the tax system, the more that subsidy, those numbers, will be skewed. And that is why I say I don't differ with the accuracy of the numbers, given the current tax system; but to me, if one is attempting the social objective of getting people to have and purchase health insurance, an equally relevant issue is: How much does it cost that individual to obtain the health insurance?

To take your three points, if I might, the credit to get them to purchase it, the equivalent of use-it or lose-it, you only get the credit if you buy health insurance. You don't have a choice of using that money for other purposes. Recognition that if you want the lower income person to buy it, you are going to have to force them to use that tax subsidy for that purpose.

Third, the value issue is simply that issue—if you look at the CBO report from a different aspect, and you take those numbers and look as a percentage of income at the value of that $83 to the $662, $83 to the very low-income person is four times the income, as is the $622 to the higher income individual. So that $82 is worth far more in increased purchasing power.

Senator **Bradley**. But if I could just get back again to the question I asked earlier. If a low-income person earning under $25,000 had the means, is it your view that he or she would choose not to have health insurance? As I recall your answer it was Yes, because, look right now, they don't.

Mr. SALISBURY. Yes, because what I am saying is, you now have a poplulation—what is generally referred to as 'the indigent population,' those without health insurance—many of those people do in fact have income that one would theorize is sufficient to buy it, and they choose not to.

Senator BRADLEY. Well, what about the 76-percent?

Mr. SALISBURY. One would assume that if they had the choice of the income instead of the insurance, their behavior would be the same as those who also have income and have chosen not to buy it. And our economic model indicated that that is about 10 million individuals who would choose to take the money instead of health insurance.

The CHAIRMAN. Senator Matsunaga.

Senator MATSUNAGA. No questions.

The CHAIRMAN. Senator Long.

Senator LONG. No questions, Mr. Chairman.

The CHAIRMAN. Mr. Salisbury, you are familiar with the criticism, some of the criticism, of the 401(k)'s and the antidiscrimination arguments. Is there anything that you would suggest to encourage more widespread use of the 401(k) plans by strengthening the nondiscrimination rules?

Mr. SALISBURY. The discrimination test to get more individuals to make use of the plan—in fact, the discrimination test is not the means to get that. And the reason I say that is because whether or not the individual chooses to put in money is an individual choice, similar to the choice to have or not have the individual retirement account.

The CHAIRMAN. Run that by me again.

Mr. SALISBURY. The discrimination test in 401(k) really only becomes a question of a limitation on what the highest income individuals can put into the plan. And it attempts, through basically saying to the higher income individual "the only way you can participate is if you can convince a large number of your lower income people to participate," and the current test does that. The effect that has had is that a large percentage of employers have put in a so-called employer match in order to basically provide that incentive.

Any discrimination test is in theory going to have that same result. The administration test has two problems with it, if you will, in that regard. One is, it narrows the test to a 10-percent versus a 90-percent of the population, versus now the upper one-third/lower two-thirds.

Particularly in a small busines situation—say 250 employees or less—that makes your upper group a very, very minute number of employees. And I will take my employment situation, 20 employees. The 10 percent would mean that group was two. And they then add a second kicker: Instead of its being an average test, as it is now, anybody in the upper one-third now can put in more than the average of the lower two-thirds, as long as the average for the full upper one third meets the test. Under the proposal from Treasury what they are saying is that it becomes a unit test; no single individual can put in more than the average of the lower two-thirds. The result could be that you could have the top group only able to put in say 4 percent of pay, while individuals in the lower group could be putting in 15 or 20 percent of pay.

The **Chairman**. Because of the average on the unit, the top is limited to the 4 percent?

Mr. **Salisbury**. That is right, because if the average of the lower group was, say, 3 percent, and you multiply a little, then it basically says no individual in the upper group could be more than 4 percent; whereas, under current law the average of the upper group would be 4 percent, which allows variable contributions for the upper one-third.

The result, from as best as we have been able to tell, is that many 401(k) plans would not meet the new nondiscrimination test, as factor A. As factor B, it would be sufficiently restrictive that it would lead many higher income individuals who make the decision of whether or not the plan should or should not be there to reconsider that.

Our own judgment is, most employers would continue to offer the plan. We don't see large numbers of plan terminations as the result of the test. We do, however, think that participation and use of matching and other things could well drop off.

The **Chairman**. I have no other questions.

Senator Long.

Senator **Long**. I have no questions, Mr. Chairman.

The **Chairman**. Senator Matsunaga.

Senator **Matsunaga**. No questions.

The **Chairman**. Senator Bradley.

Senator **Bradley**. Thank you, Mr. Chairman.

If I could, I would like to try to get a fix on this again. You said 76 percent of all taxpayers who have employer-paid health earn under $25,000?

Mr. **Salisbury**. According to the Census Bureau's current population survey data, yes.

Senator **Bradley**. OK. How many taxpayers are there? About 104 million?

Mr. **Salisbury**. Right.

Senator **Bradley**. How many taxpayers earn under $25,000?

Mr. **Salisbury**. My memory says 83 percent.

Senator **Bradley**. Eighty-three percent?

Mr. **Salisbury**. Right.

Senator **Bradley**. And 76 percent of that group?

Mr. **Salisbury**. No. Seventy, if you take all of the individuals, 83 percent of them. Eighty-three percent of the whole.

Senator **Bradley**. But what about the numbers, because you said 10 million would opt out, and then you used percentages. How many is 76 percent of the taxpayers who use employer-paid health?

Mr. **Salisbury**. About fifty-one million people.

Senator **Bradley**. So, 67 million people are now covered under the $25,000 level?

Mr. **Salisbury**. No. Excuse me. The 67 million is the total number who pay taxes and report income; 76 percent of those earned less than $25,000.

Senator **Bradley**. So that is about 45 million?

Mr. **Salisbury**. Fifty-one million.

Senator **Bradley**. So 51 million is the number here that are under $25,000. And your figure is extrapolating from the behavior of what income level?

Mr. **Salisbury**. Twenty-five thousand or less.

Senator **Bradley**. No, no, no. You said that here is a group of very poor who don't have——

Mr. **Salisbury**. We ran the econometric model against all income levels. I would be happy to submit that to you.

[The information follows:]

Appendix B
EBRI Simulation of Private Health Insurance Coverage under Full Taxation of Employer Contributions

The simulation of the rate and distribution of private health insurance coverage that might emerge in the absence of tax-exempt employer contributions to coverage was conducted in two stages. In stage one of the simulation, the determinants of private health insurance coverage were estimated among workers and members of worker families who received no employer contribution to the coverage of any family member in 1979. These persons were selected from a 15-percent random sample of the March 1980 Current Population Survey (CPS) data. In order to perform the estimation, the CPS data were reorganized to: (1) identify family units within the household unit reported in the CPS; (2) eliminate noncivilian or agricultural workers and their families, as well as nonworkers and their families; (3) identify the source of coverage for each person reporting coverage by an employer group plan during 1979; and (4) identify the primary earner in the family.

The determinants of coverage among workers and members of worker families who received no employer contribution to their coverage (if covered by an employer plan) or to the coverage of the primary earner (if not covered by an employer plan) were estimated by ordinary least-squares (OLS) regression. The OLS estimates were then adjusted to produce the values that would have been yielded by a probit estimation technique.[1]

In stage two of the analysis, the adjusted estimates were applied to the values of the relevant variables among, respectively, workers and members of worker families who reported an employer contribution either to the individual's own coverage (if covered) or to the primary earner's coverage (if not covered by an employer group plan). The results were then aggregated to produce the simulated probability of coverage among workers and their families under full taxation of employer contributions to coverage. The simulated probability of coverage by various worker and family characteristics was presented in chapter IV.

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[1] This adjustment procedure is described in William H. Greene, "Estimation of Limited Dependent Variable Models by Ordinary Least Squares and Method of Moments," *Journal of Econometrics* (1983), pp. 195–212.

The following sections describe the characteristics of families included in the estimation and simulation procedures, and present the OLS and probit estimates used in the simulation.

Family Characteristics

Among all persons in families of wage and salary workers in 1979, nearly one-quarter belonged to families that received no employer contribution to health insurance coverage. Although the characteristics of families with no employer contribution to health coverage differed substantially in some respects from those that did receive an employer contribution, the magnitude of within-group variances generally precluded statistically significant differences between groups. Family income among persons with no employer contribution to coverage within the household, for example, was less than half the income of persons in families that received an employer contribution; nevertheless, levels of income within each group varied so widely that the difference between groups was not statistically significant. Among persons in families without an employer contribution, the head of family was slightly younger and the number of dependent children was slightly lower. These differences are reported in table B.1. The general similarity of these groups (discounting, perhaps, the large but statistically insignificant difference in average family income) implies that the coverage decisions of families without an employer contribution might reasonably represent the decisions that would occur among the general population in the absence of tax-encouraged employer contributions to health coverage.

Two differences among these populations are noteworthy, however. First, the economic structure of the family differs between the populations. Persons who reported no employer contribution to health coverage within the family were much more likely to live in either a female-headed household or a single-adult household, than persons in families which received an employer contribution. This difference in family composition, coupled with significantly lower average earnings levels among women, may account for some of the discrepancy in family income between the two groups.

Second, among persons in families without an employer contribution to health coverage, only 19 percent had employer group coverage during 1979. This rate contrasts with more than 90 percent

TABLE B.1

Distribution and Selected Characteristics of Nonelderly Persons in Worker Families by Employer Contribution to Health Insurance Coverage, 1979[a]

Characteristic	Employer Contribution to Coverage[b]	No Employer Contribution to Coverage
Percent of All Persons	77.0	23.0
Percent with Employer Group Coverage	92.3[c]	20.2
Average Family Income (in thousands)[d]	24.3	13.8
	(13.5)[e]	(13.3)
Average Age, Head of Family[f]	38.1	34.3
	(11.4)	(13.6)
Average Annual Unemployment (in weeks), Head of Family	1.0	3.0
	(4.2)	(8.1)
Percent in Family of Full-time Worker	97.5	76.9
Percent in Family with Spouse Present	80.0	54.0
Percent with Public Program Coverage[g]	5.4	20.2
Percent in Female-headed Family	79.7	59.6
Average Number of Children in Family under Age 18	1.4	1.4
	(1.4)	(1.5)

Source: EBRI tabulations of the March 1980 Current Population Survey (U.S. Department of Commerce, Bureau of the Census).

[a] Includes only persons under age 65 living in families of wage and salary workers.

[b] Employer contribution to coverage reported by: (1) the individual's source of coverage (if covered); or (2) the primary family earner (if not covered).

[c] Percent less than 100 reflects non-coverage of a dependent under a worker's plan to which the worker's employer contributes.

[d] Includes income from private sources only.

[e] Standard deviations are presented in parentheses.

[f] Head of family is the family member with the greatest earnings in 1979.

[g] Persons with coverage from Medicare, Medicaid or CHAMPUS during 1979.

among persons in households that did receive an employer contribution. The much lower coverage rate among the population with no employer contribution probably reflects limited access to employer group coverage without an employer contribution, as well as household decisions not to take coverage in the absence of an employer contribution. The results of our simulation might change if access to favorable group coverage without an employer contribution were improved. Nevertheless, it is unlikely that low-income persons would show significant gains in coverage.

Rates of Health Insurance Coverage

Rates of private and public health insurance coverage among persons without an employer contribution are reported in table B.2. Private health insurance coverage is defined as coverage from an employer group plan or other private health insurance plan. In the absence of an employer contribution to health coverage within the household, fewer than half (43 percent) of all persons living in worker families reported private health insurance coverage during any part of the year. The rate of private coverage among work-force participants without an employer contribution was 50 percent greater than the rate of private coverage among all persons living in worker families with no employer contribution. This suggests that workers' dependents are the persons least likely to have private health insurance coverage in the absence of an employer contribution to coverage.

Almost 30 percent of all persons without private health insurance coverage reported eligibility for coverage by Medicare, Medicaid, or CHAMPUS. Medicaid was an especially important source of coverage among these persons. Nearly 23 percent of persons without private health insurance coverage and no employer contribution to coverage within the family were eligible for Medicaid.

Despite relatively high rates of public program coverage, 71 percent of all persons in worker families without an employer contribution to health coverage, and 77 percent of all workers without an employer contribution, reported no coverage by either private insurance or any public program during 1979. This rate is about 90 times the rate of no coverage reported among persons living in families with an employer contribution to health insurance.

The Determinants of Private Health Insurance Coverage

The determinants of private health insurance coverage among, respectively, workers and persons living in worker families without an

TABLE B.2

Distribution of Nonelderly Persons and Workers with No Employer Contribution to Health Insurance Coverage by Public and Private Sources of Coverage, 1979 (Percents)

Source of Public Coverage	Persons with Private Coverage	Persons without Private Coverage
All Persons:[a]	43.0	57.0
Medicare	2.2	2.5
Medicaid	3.3	22.8
CHAMPUS	2.3	4.9
Total with Public Coverage[b]	7.6	29.4
Total with No Public Coverage	92.4	70.6
Workers:[c]	64.8	35.2
Medicare	2.2	2.3
Medicaid	2.4	16.7
CHAMPUS	2.5	5.2
Total with Public Coverage	6.9	23.3
Total with No Public Coverage	93.1	76.9

Source: EBRI tabulations of the March 1980 Current Population Survey (U.S. Department of Commerce, Bureau of the Census).

[a] Includes only nonelderly persons residing in worker households.

[b] Components of public-sector coverage do not add to the public-sector total because some persons are eligible for benefits from more than one program.

[c] Includes full-time, part-time, full-year, and part-year wage and salary workers under age sixty-five; excludes self-employed and unpaid workers, and persons in the Armed Forces.

employer contribution to coverage are presented in tables B.3 and B.4. Significant determinants of private health insurance coverage among workers without an employer contribution to coverage were:

- family income (including transfer income) and family income, squared;
- the number of weeks that the worker was involuntarily unemployed;
- the worker's sex (0 = M, 1 = F);
- the worker's age;
- the presence of a spouse in the household (0 = no, 1 = yes); and
- eligibility for coverage from Medicare, Medicaid, or CHAMPUS.

TABLE B.3
Determinants of Private Health Insurance Coverage: Coefficient Estimates for Workers with No Employer Contribution

Variable	OLS Estimate	Probit Approximation
Intercept	0.15788^{a}	−1.77851
CHILD	−0.00440	−0.02985
INCOME	0.01663^{a}	0.11271
INCOME^{2}	−0.00015^{a}	−0.00102
UNEMPLOYED	−0.00408^{b}	−0.02762
SEX	−0.08489^{a}	−0.57528
AGE	0.00445^{a}	0.03015
SPOUSE	0.10382^{a}	0.70352
PUBLIC	−0.14945^{a}	−1.01273
n (unweighted)	2,711	2,711
n (weighted)	10,546,364	10,546,364
R^2 (adjusted)	0.5468	0.8618

Source: Employee Benefit Research Institute.
[a] Significant at .99 (two-tailed test).
[b] Significant at .95 (two-tailed test).

Using these independent variables, an ordinary least-squares regression over all nonelderly workers (unweighted n = 2,711) explained nearly 55 percent of total variation. The probit adjustment yielded estimates that explained more than 86 percent of total variation, increased the size of the coefficients, and left their signs unchanged.

Among all persons in worker families without an employer contribution to coverage, significant determinants of private health insurance coverage included the presence of dependent children in the household, but were otherwise similar:

- the number of family members under age eighteen living in the household;
- family income (including transfer income), and family income, squared;
- the number of weeks during which the primary family earner was involuntarily unemployed;
- the sex of the primary family earner (0 = M, 1 = F);
- the age of the primary family earner;
- the presence of a spouse in the household (0 = no, 1 = yes); and
- eligibility for coverage from Medicare, Medicaid, or CHAMPUS.

Using these independent variables, an ordinary least-squares regression over all nonelderly persons living in worker families

TABLE B.4

Determinants of Private Health Insurance Coverage: Coefficient Estimates for Persons in Worker Families with No Employer Contribution

Variable	OLS Estimate	Probit Approximation
Intercept	0.15508[a]	−1.29980
CHILD	−0.01737[b]	−0.10848
INCOME	0.01803[a]	0.11265
INCOME^2	−0.00017[a]	−0.00103
UNEMPLOYED	−0.00363[a]	−0.02270
SEX	−0.02841[b]	−0.17745
AGE	0.00339[a]	0.02118
SPOUSE	0.09007[a]	0.56264
PUBLIC	−0.14158[a]	−0.88438
n (unweighted)	4,837	4,837
n (weighted)	39,810,726	39,810,726
R^2 (adjusted)	0.5262	0.8342

Source: Employee Benefit Research Institute.

[a] Significant at .99 (two-tailed test).

[b] Significant at .95 (two-tailed test).

($n = 4,837$) explained 53 percent of total variation in private coverage rates. The probit adjustment again sharply raised the explanatory power of the estimating equation and increased the magnitude of the coefficient estimates without changing their signs.

The Effect of Income on Private Health Insurance Coverage

In the absence of an employer contribution to health insurance coverage, the effect of family income on rates of private health insurance coverage is significant. Among workers and, collectively, workers and their dependents who receive no employer contribution, the probability of private health insurance coverage at any time during the year drops dramatically at lower levels of family income.

These results have important implications. Employer contributions to health insurance coverage are particularly important in raising "normal" rates of private health insurance coverage among low-income workers and their dependents. Conversely, a reduction in tax incentives for employers to contribute to health insurance is likely to affect disproportionately the rate of private health insurance coverage among low-income workers and their families.

The Effect of Family Characteristics on Private Health Insurance Coverage

Demographic and social characteristics of families—the age and sex of the family head and the presence of a spouse in the household—are also significant determinants of private health insurance coverage among workers and persons in worker families without an employer contribution to coverage. The growth of single-person households and single-parent households over the last decade, as well as the projected growth of these households through 1990, suggests that demographic and social trends should not be overlooked in setting tax policy toward private health insurance.

The composition of households in the United States has shifted dramatically since 1970. Between 1970 and 1981, the number of adults living alone increased by 75 percent. In 1981, single-person households constituted 23 percent of all households in the United States. Growth in young single-person households has been particularly strong. Persons living alone under the age of twenty-five nearly tripled during the last decade.

The number of children living in single-parent households also grew rapidly. Between 1970 and 1981, the number of children residing in single-parent households rose by two-thirds. In 1981, 20 percent of all children under the age of eighteen (12.5 million children) were living in single-parent households.

The significance of demographic and social family characteristics in determining rates of private health insurance coverage has startling implications for tax policy. Controlling for all other factors, the probability of private health insurance coverage among single workers in the absence of an employer contribution is significantly lower than the probability of coverage among workers living with a spouse. Similarly, relatively low rates of coverage occur among all persons living in single-adult families compared to persons living in families with a spouse present. The presence of dependent children in the family reinforces the effect of no spouse present in determining the probability of private health insurance coverage. Everything else being equal, children living in a single-parent family are about half as likely as children living in a two-parent family to have private health insurance coverage when an employer does not contribute.

These findings have at least two implications. First, employer contributions to health insurance have probably been pivotal in maintaining high rates of health insurance coverage among workers and their families despite perverse demographic and social trends. In the absence of tax incentives for employers to provide or contribute to coverage, rates of coverage among unmarried workers, among young workers, and among workers' dependents might be significantly lower.

Second, these findings suggest that the subsidization of some workers that results when employers provide or contribute most of the cost of health insurance is probably important to high rates of coverage among all workers and their families. The importance of demographic characteristics in determining rates of private health insurance coverage when an employer does not contribute implies that a reduction in tax-exempt employer contributions might generate significant changes in coverage by employee age, sex and family composition. These changes, in turn, are likely to alter the price of health insurance coverage to persons who represent greater health care risks and would be, all else equal, most likely to purchase coverage. As a result, the simulated coverage rates among low-income families presented in chapter IV may be generous estimates of the actual coverage rates that would occur after price adjustments, were employer contributions to health insurance coverage fully taxable. Similarly, the simulation results by other worker or family characteristics do not reflect adjustments in the price of coverage that might follow taxation of employer contributions.

The Effect of Public Program Eligibility on Private Health Insurance Coverage

For both workers and persons living in worker families, eligibility for coverage by a public insurance program—usually Medicaid—significantly reduced the probability of private health insurance coverage in the absence of an employer contribution. The substitution of public program coverage for private health insurance coverage suggests a potentially important relationship between federal tax policy toward private health insurance coverage and public program costs. By raising rates of private coverage among low-income workers and their dependents, tax policy that encourages employer contributions to health insurance probably reduces the demand for publicly-financed health care. While removing the tax exemption for employer contributions to health insurance promises some revenue yield, therefore, it also promises to raise public program spending. The research presented in this volume cannot provide a precise estimate of the growth of public program spending that might occur were tax preferences for private health insurance coverage eliminated. This research does, however, suggest that tax revenue estimates related to the full taxation of employer contributions to health insurance should include estimation of potentially significant increases in spending by Medicare and Medicaid.

Senator BRADLEY. But you say 10 million, then, would opt out?

Mr. SALISBURY. The number produced out of the model was that 10 million could be expected to opt out.

Senator BRADLEY. I would like to see the assumptions behind the model. In other words, if your behavior is you assume people who have health insurance now earning under $25,000 would choose to take cash, and you make that assumption based upon the behavior of people who under the current system don't buy health insurance, I really wonder if you are comparing apples and oranges. And I would like to see the data that indicates that a single mother with five kids would behavior that she chooses would be the same as a $22,000 family with five kids.

Mr. SALISBURY. That is not the basis on which it was done. The basis on which the model matched was, if you have a single working mother with five kids making $22,000 and getting health insurance now from Chrysler Corp., if you assume that individual would behave the same as the working mother with five kids and $22,000 in income who now chooses not to buy health insurance because her employer does not have it. And you would use that first case of the noncovered, you match it with those who have health insurance and work for similar population-type individuals, and look at what if their behavior was the same. But I will provide you with the full study done by Dr. Chollet.

Senator BRADLEY. Good. I would appreciate that.

[The full study follows:]

IV. Revising Federal Tax Preferences for Health Insurance Expenditures

Federal tax preferences for the purchase of health insurance take two forms: (1) the deduction allowed for individual purchase of health insurance under the individual income tax code; and (2) the exemption of employer contributions to health insurance from individual income and Social Security taxes, as well as the deduction of health insurance contributions from corporation income tax. These tax preferences, particularly the tax exemption of employer contributions, have encouraged the growth of health insurance coverage among the population and the emergence of plans that provide broader, more complete coverage for health care services. This chapter summarizes the tax laws that affect the purchase of health insurance, either by individuals or as an employee benefit; reviews past research on the effects of tax preferences for health insurance; and evaluates the possible outcomes of proposals to reform tax preferences for employer contributions to health insurance.

Tax Laws Affecting Health Insurance Expenditures

The federal tax laws affecting health insurance purchases distinguish between the purchase of health insurance by individuals and the purchase of health insurance by employers on behalf of employees. From 1965 through 1982, the individual income tax code allowed the deduction of one-half of all expenditures for health insurance, up to a maximum deduction of $150.[1] Additional expenditures for health insurance were fully deductible if, together with all other health-related expenditures, they exceeded 3 percent of adjusted gross income.[2]

The 1982 Tax Equity and Fiscal Responsibility Act (TEFRA) eliminated the separate deduction for health insurance premiums and raised the income floor for health expenditure deductions to 5 percent of adjusted gross income, effective in 1983. TEFRA discourages individual spending for health insurance relative to pre-TEFRA tax incentives. In addition, it widens the disparity between the tax treatment of individual expenditures for health insurance and the tax treatment of employer contributions to health insurance.

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[1] Public Law 89-97, Social Security Amendments of 1965, established the deductibility of individual expenditures for health insurance below the adjusted gross income floor that governs the deductibility of other medical expenses.

[2] Adjusted gross income is gross income net of: (1) the costs of earning income; and (2) specific forms of tax-deferred or tax-exempt income.

Employer contributions to health insurance, like most employee benefits, are exempt from the taxes levied on wage and salary income. Employer contributions are not considered taxable income to the employee and are, therefore, exempt from both the individual income tax and the Social Security tax on earnings. Similarly, since employer health insurance contributions are treated as nonwage compensation of employees, employers pay no Social Security tax on them.[3] Finally, employer health insurance contributions are deductible under the corporation income tax as a business expense.

The value of these exemptions, and the incentives they offer for expanded health insurance coverage, have grown significantly over the last decade. The enhanced value of exemptions is the result of increases in effective marginal tax rates during a period of persistent price inflation, the rising cost of health insurance coverage, and the expansion of health coverage as an employee benefit. Between 1972 and 1982, the value of health insurance exemptions from federal taxes rose at an annual nominal rate of nearly 20 percent. The 1983 value of the federal exemptions of employer health insurance contributions has been estimated at $16.4 billion. By comparison, the estimated 1983 value of individual health care expense deductions, including health insurance expenditures, is $4.2 billion.[4] The parallel preferences given to private health insurance purchases under state and local tax laws further raises the value of federal tax preferences for health insurance.

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[3] The exclusion of employer contributions to health insurance was supported by a special Internal Revenue Service ruling in 1943 (Special Ruling, October 26, 1943, 433CCH, Federal Tax Service, par. 6587). The uniform exclusion of all employer contributions to accident or health insurance plans was finally legislated into the tax code in 1954.

[4] U.S. Congress, Congressional Budget Office, *Tax Expenditures: Budget Control Options and Five-Year Budget Projections for Fiscal Years 1983–1987* (November 1982), table A-1. These estimates do not reflect the amount of tax revenue that might result from federal taxation of employer health insurance contributions. In particular, they do not reflect many behavioral changes that might follow a revision of tax incentives. However, projections of tax revenues that might be gained from full or partial taxation of employer contributions typically assume that 15 to 25 percent of newly taxable health care benefits would be replaced by nontaxable benefits.

Growth of Employer Contributions to Health Insurance

Since 1965, employer contributions to health insurance as a share of total compensation have doubled. This has alarmed some who view the growth of health insurance benefits as an erosion of the tax base, and as a threat to the public sector's ability to finance government programs. In addition, growth of employer contributions to health insurance has become popularly equated with the emergence of "generous" health insurance coverage, a corresponding reduction in insured consumers' out-of-pocket health care costs, and an increasing stimulus to inflation in health care costs.

The growth of employer contributions as a share of compensation can be broken into several components. These include: (1) growth in the share of all workers covered by an employer group health plan, as well as in coverage of dependents under these plans; (2) inflation in health care costs that has persistently exceeded the growth of average compensation; (3) increases in private insurance costs, including the effects of cost shifting by public insurance programs; and (4) enhancement of benefits provided by employer group plans.

Several factors have encouraged the growth of employer group health insurance among workers and their families. Economies of scale associated with insuring larger employee groups have encouraged the inclusion of lower-income, part-time, and seasonal workers in employer group plans. The growth of real marginal tax rates has raised the demand for tax-exempt employee benefits, including employer contributions to health insurance coverage. Finally, the relative cost of individually purchased health insurance has risen as preferred risks (prime-age, working adults and their families) have been absorbed into employer group plans. This has raised the demand for employer coverage relative to more expensive individual coverage.

Much of the data necessary to measure the growth in employee coverage or in the other components of employer contributions have not been compiled. Available data do allow, however, estimation of the direct effect of inflation on growth of employer contributions to health insurance. The real growth of employer contributions to health insurance, deflated for the increase in medical care prices in excess of aggregate inflation rates, is presented in table IV.1. Between 1970 and 1982, the real value of employer contributions—reflecting growth in the proportion of workers and their dependents covered by employer group plans, insurance costs and benefit enhancement—as a share of real compensation grew at an average annual rate of 4.6 percent. Between 1975 and 1982 the real growth of employer contri-

TABLE IV.1

Inflationary and Real Components of Employer Contributions to Group Health Insurance Benefits, for Selected Years 1965–1982

Year	Nominal Employer Contributions as a Percent of Compensation	Inflation Adjustment as a Percent of Compensation[a]		Real Benefits and Insurance Cost as a Percent of Compensation	
		Amount	Percent of Contribution	Amount	Percent of Contribution
1965	1.5	—	—	1.5	100.0[b]
1970	1.9	0.1	5.3	1.8	94.7
1975	2.7	0.2	7.4	2.5	92.6
1976	2.8	0.3	10.7	2.5	89.3
1977	3.0	0.3	10.0	2.7	90.0
1978	3.0	0.3	10.0	2.7	90.0
1979	3.0	0.3	10.0	2.7	90.0
1980	3.1	0.3	9.7	2.8	90.3
1981	3.1	0.5	16.1	2.6	83.9
1982	3.5	0.4	11.4	3.1	88.6
Average Annual Growth:					
1970–1982	5.2	12.2	6.6	4.6	−0.6
1975–1982	3.8	10.4	6.4	3.1	−0.6
1980–1982	6.3	15.5	8.4	5.2	−0.9

Sources: EBRI estimates from the National Income and Product Accounts (U.S. Department of Commerce); 1965–1974: U.S. Department of Commerce, *National Income and Product Accounts 1929–1974* (1977), tables 6.5 and 6.13; 1975: *Survey of Current Business* (July 1976), tables 6.5 and 6.13; 1976–1979: *Survey of Current Business*, Special Supplement (July 1981), tables 6.5 and 6.13; 1980–1981: *Survey of Current Business* (July 1982), tables 6.5 and 6.13; and 1982: *Survey of Current Business* (July 1983), tables 6.5 and 6.13.

[a] Estimate is based on levels of a fixed-weight price index for personal health care expenditures between 1965 and 1982 constructed by the U.S. Department of Health and Human Services, Health Care Financing Administration, the Division of National Cost Estimates. Values of the index are unpublished.

[b] Because base prices are assumed at the 1965 level, all employer contributions to health insurance are defined as real benefits in 1965.

butions slowed to 3.1 percent. During 1981, the level of real employer contributions as a share of real compensation actually declined from the 1980 level, but accelerated rapidly in 1982. Employer adjustments for inflation in health care costs, by comparison, rose at an average annual rate of more than 12 percent between 1970 and 1982, and by nearly 16 percent between 1980 and 1982. In 1982, 11 percent of all employer contributions to health insurance reflected simply the increase in health service prices in excess of general price inflation since 1965.

The Effect of Tax Preferences

Tax preferences for health insurance, in effect, reduce the after-tax price of insurance to purchasers. The full exemption of employer contributions to health insurance, for example, is equivalent to allowing employees to purchase health insurance coverage with before-tax dollars of income. This is advantageous to the workers who pay for a dollar of health insurance by foregoing a dollar of earnings *minus* the amount of the worker's marginal tax rate on wage and salary income.[5] It is also advantageous to employers, who save the amount of Social Security tax that would have been levied on health insurance contributions were they paid to employees in the form of wages.

Since the earnings of most workers fall below the Social Security ceiling on taxable earnings, the amount of the savings to employers is significant. In 1982, each dollar of health insurance contributed in lieu of wage compensation to employees earning below the taxable ceiling represented a net employer saving of 6.7 cents, or a discount of 6.7 percent on the cost of health insurance relative to wage compensation. As the Social Security ceiling on taxable earnings has increased, moreover, the proportion of payroll against which insurance contributions represent net employer savings has gradually risen.

Effective real marginal tax rates among employees have increased as a result of: (1) the individual income tax not being indexed for inflation; and (2) statutory increases in the Social Security tax rate. These increases in effective real marginal tax rates have steadily reduced employees' after-tax price of health insurance "purchased" through an employer.

Increases in the Social Security tax rate and in effective real marginal tax rates under the individual income tax have provided incentives for both employers and workers to prefer greater health insurance benefits to wage increases. Nevertheless, econometric estimates of the impact of tax preferences on the growth of employer health insurance expenditures indicate that tax preferences may have been a relatively small factor in the growth of employer contributions to health insurance. Using annual time-series data, Long and Scott[6] estimated that each 10 percent increase in the average marginal tax rate has raised the percentage of compensation paid in life and health insurance benefits by 4 percent.[7] Woodbury[8] produced estimates of the same general magnitude using pooled time-series cross-sectional data on the compensation of employees of independent school districts.

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[5] In 1982, a dollar of income to the median employed worker before taxes was equivalent to approximately seventy-one cents in after-tax income. Health insurance purchased with a dollar of before-tax income, therefore, cost the employee only seventy-one cents in after-tax income, a 29-percent discount on the price of insurance. This estimate excludes the value to the employee of the exemption from state and local tax, as well as the value of earnings that would have been diverted to the employer share of the Social Security tax.

From these econometric estimates, it is possible to roughly appraise the effect of tax incentives on the historic growth of employer contributions to health insurance. Between 1970 and 1982, the average taxpayer's real marginal tax rate rose from about 19 percent to more than 23 percent, an increase of more than one fifth.[9] If 0.4 is used as an estimate of the sensitivity of employer contributions to changes in the real marginal tax rate, the growth of real marginal rates between 1970 and 1982 (independent of other factors) may have raised real employer contributions to health insurance as a share of compensation by about 9 percent. This amount, equivalent to a 0.2 percentage-point increase in the ratio of real employer contributions to real compensation since 1970, represents about 13 percent of the total real growth in employer contributions that occurred.

The tax-exempt status of employer contributions to health insurance may affect the growth of employer contributions in several ways. Tax incentives may encourage: (1) growth in the number of workers who participate in an employer group plan; (2) accommodation of health care cost inflation by employer plans; (3) enhancement of benefits provided by employer group plans; and, consequently, (4) further inflation in health care costs. Each of these effects is discussed in turn.

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[6] James E. Long and Frank A. Scott, "The Income Tax and Nonwage Compensation," *Review of Economics and Statistics* (May 1982), pp. 211–219.

[7] Employer contributions to life insurance represent a small portion of the life-health insurance aggregate used in these studies. In 1982, employer contributions to life insurance were 0.3 percent of compensation; in contrast, health insurance contributions were 3.5 percent of compensation. (EBRI estimates from the National Income and Product Accounts, U.S. Department of Commerce.)

[8] Stephen A. Woodbury, "Substitution Between Wage and Nonwage Benefits," *American Economic Review* (March 1983), pp. 166–182.

[9] The change in marginal tax rates for the average taxpayer used here is a rough arithmetic approximation from published data. Computations were derived as a weighted average of tabulations and estimates presented in U.S. Department of Commerce, *Statistical Abstract of the United States 1982–83*, tables 431, 434 and 437. These estimates uniformly exclude the effect of the Social Security tax exemption on the growth of employer contributions to health insurance.

Growth in Rates of Worker Participation—Growth in the rate of worker participation in employer group health plans as a result of tax preferences, although likely, is undocumented. Tax incentives for employers to provide health insurance contributions in place of wage compensation among workers whose earnings fall below the Social Security taxable ceiling have probably resulted in greater employer provision of health insurance—and higher rates of participation among middle- and lower-income workers—than would have resulted from individual income tax incentives alone. Similarly, the regressivity of the Social Security tax on workers encourages lower-wage workers, who might otherwise prefer cash compensation, to demand employer contributions to health insurance. These incentives have been steadily rising over time, as the Social Security tax rate and the proportion of workers whose earnings are fully taxed by Social Security have risen (see table IV.2). By implication, the rate of worker participation in employer group health plans among lower-income employees is probably higher than it would be in the absence of tax preferences.

Accommodation of Health Care Cost Inflation—Rising real tax rates (and consequently, the effective discounting of insurance costs) have probably encouraged employers and employees to accommodate health care cost inflation within the cost of group health plans. Analysis of data from a 1971 national survey of establishments suggests that the adjustment of employer contributions in response to insurance price increases is generally less than proportional to the price increase.[10] As a result, employer contributions to health insurance increase as insurance prices rise. By supporting greater health insurance coverage and benefits despite rising insurance prices, employers have largely absorbed inflation in the cost of health care. The increased tax incentives that have accompanied inflation in health care costs have probably offset employer incentives to revise their health plans in response to rising plan costs.

Enhancement of Plan Benefits—The growth of employer health insurance contributions probably also reflects the emergence of broader

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[10] G.S. Goldstein and Mark V. Pauly, "Group Health Insurance as a Local Public Good," in Richard N. Rosett, ed., *The Role of Health Insurance in the Health Services Sector* (New York: National Bureau of Economic Research, 1976). The price of health insurance is usually defined as the loading on the premium; that is, the amount of the premium net of the expected value of benefits to the insured. Although the estimates produced by Goldstein and Pauly are based on cross-section data (implicitly holding the expected value of benefits constant), the estimates can be generalized to employer responses over time. The loading on an insurance premium is usually formulated as a proportion of the expected value of claims. By raising the expected value of claims, inflation in health care costs raises the level of health insurance premiums net of the value of claims.

TABLE IV.2

Social Security Tax Rates, Maximum Taxable Payroll, Taxable Payroll as a Percent of Total Payroll, and the Percent of Workers with Earnings below the Taxable Maximum, in Selected Years 1960–1983

Year	Tax Rate (Percent)	Maximum Taxable Wages and Salaries	Reported Taxable Wages and Salaries as a Percent of Total Wages and Salaries	Percent of Workers with Earnings below Social Security Taxable Maximum
1960	3.0	$ 4,800	79.9	72.6
1965	3.6	4,800	74.1	64.9
1970	4.8	7,800	80.4	74.9
1975	5.8	14,100	86.6	85.8
1976	5.8	15,300	86.4	85.8
1977	5.8	16,500	86.1[a]	85.9
1978	6.1	17,700	85.6	85.9
1979	6.1	22,900	89.2	90.5
1980	6.1	25,900	90.0[a]	91.5[a]
1981	6.6	29,700	90.4[a]	93.0[a]
1982	6.7	32,400	90.7[a]	93.5[a]
1983	6.7	35,700	91.2[a]	94.5[a]

Sources: U.S. Department of Health and Human Services, Social Security Administration, *Social Security Bulletin: Annual Statistical Supplement*, 1982, table 21, p. 77; and unpublished data provided by the Social Security Administration.

[a] Preliminary data.

and more complete coverage under employer group plans. Direct estimates of the effect of tax preferences on the provisions of employer group coverage do not exist. Research on the relationship between the prices of health insurance and the provisions of individually purchased coverage, however, suggests that tax preferences probably affect the kind of coverage offered by employer group plans. Based on a household survey of individual coverage, Phelps[11] found that households respond to lower insurance prices by choosing higher benefit maximums (for hospital, surgical, and medical coverage) and lower effective rates of coinsurance. Phelps estimated that a 10-percent reduction in the price of insurance decreased the share of costs that consumers directly assumed (net of insurance) by as much as 6 percent. Since Phelps' study relies on an indirect measure of insurance price, however, his estimate serves only as an approximation of the response of consumers to marginal changes in insurance prices—including, presumably, differences in the tax-price of insurance.[12] Nevertheless, tax preferences for employer health insurance contributions have probably encouraged more generous coverage than might otherwise prevail.

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[11] Charles E. Phelps, "Demand for Reimbursement Insurance," in Rosett, ed., *The Role of Health Insurance in the Health Services Sector.*

Inflation in Health Care Costs—Research demonstrating a relationship between comprehensive health insurance coverage and inflation in the cost of health care is extensive. Based on estimates reported by Newhouse and Phelps[13], Ginsburg[14] calculated that a reduction in hospital coverage from full coverage to 25 percent copayment by the patient reduces expenditures for hospital care by 17 percent. Using preliminary data from a nationwide private health insurance experiment, Newhouse *et al.*[15] concluded that people who have insurance plans with relatively high copayment provisions experience fewer hospital admissions and, consequently, incur significantly lower expenditures for hospital care than other people. Among hospitalized patients, Newhouse found no significant relationship between greater cost-sharing and rates of inpatient service use or cost. Earlier research, however, associated more complete insurance coverage with both higher hospital admissions and higher costs per patient day.[16]

The study reported by Newhouse *et al.*, as well as earlier empirical research (Fuchs and Kramer[17], Newhouse and Phelps[18], Scitovsky and

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[12] Woodbury (in "Substitution Between Wage and Nonwage Benefits") defines the tax-price of a dollar of nonwage compensation as (1 minus t) where *t* is the employee's marginal tax rate on wage compensation. In general, the tax price of health insurance received as an employee benefit is the difference between the nominal or "own" price of insurance and the worker's (or employer's) additional tax liability if the price were imputed as wages.

[13] Joseph P. Newhouse and Charles E. Phelps, "New Estimates of Price and Income Elasticities," in Rosett, ed., *The Role of Health Insurance in the Health Services Sector*.

[14] Paul B. Ginsburg, "Altering the Tax Treatment of Employment-Based Health Plans," *Milbank Memorial Fund Quarterly/Health and Society* (Spring 1981), pp. 224–255.

[15] Joseph P. Newhouse *et al.*, "Some Interim Results from a Controlled Trial of Cost Sharing in Health Insurance," *New England Journal of Medicine* (1981), pp. 1501–1507.

[16] Martin S. Feldstein, "The Quality of Hospital Services," in Mark Perleman, ed., *The Economics of Health and Medical Care* (New York: John Wiley and Sons, 1974); Joseph P. Newhouse, "Insurance Benefits, Out-of-Pocket Payments, and the Demand for Medical Care: A Review of the Literature," *Health and Medical Care Services Review* (1978), pp. 3–15.

[17] Victor R. Fuchs and M.J. Kramer, *Determinants of Expenditures for Physicians' Services in the United States, 1948–1968* (Washington, D.C.: National Bureau of Economic Research, December 1972).

[18] Newhouse and Phelps, "New Estimates of Price and Income Elasticities."

McCall[19], and Hixson[20]) suggest that more complete insurance coverage also results in higher costs for physician care. Higher costs result from: (1) greater use of physician services among persons with more complete coverage; and (2) differences in physician charges for comparable services. The effect of insurance coverage for physician charges has been explained in terms of the propensity of physicians to structure their fees on insurers' reimbursement schedules[21], and the propensity of patients to reduce their search for less expensive care when their share of the cost is relatively low. The estimates produced by Newhouse *et al.*, however, suggest that the effect of insurance on consumers' search activity and, consequently, on the prices charged, is probably trivial.

Comparable research on price markups by hospitals in response to insurance is scarce. Research by Sloan and Becker[22] indicates that the prices charged to privately insured patients absorb a portion of the discounts that hospitals allow Medicare and Medicaid patients. The shifting of these discounts into hospital charges to privately insured patients may explain the significantly higher cost per patient day among privately insured patients that is occasionally observed in the literature. In this case, the price markup attributed to private health insurance is inflated by the discounting of hospital charges to publicly insured patients.

Proposals to Reform Tax Preferences for Health Insurance

Proposals to modify federal tax preferences for health insurance expenditures are of two types: (1) those that would place a ceiling on the exemption of employer health insurance contributions in order to encourage greater cost sharing as a feature of employer group plans; and (2) those that would eliminate all tax preferences for employer health insurance contributions within the framework of comprehensive tax reform. Proposals of the first type, those that would

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[19] Anne Scitovsky and Nelda McCall, "Coinsurance and the Demand for Physicians' Services: Four Years Later," *Social Security Bulletin* (1977), pp. 17–27.

[20] J. Hixson, "The Aggregate Supplies and Demand of Physician and Dental Services," in J. Hixson, ed., *The Target Income Hypothesis*, DHEW Pub. No. (HRA) 80-27 (Washington, D.C.: Government Printing Office, 1980).

[21] Frank A. Sloan, "Effects of Health Insurance on Physicians' Fees." Paper presented at the Annual Meeting of the Southern Economics Association, Washington, D.C. (November 6, 1980).

[22] Frank A. Sloan and Edmund R. Becker, "Cross-Subsidies and Payment for Hospital Care," in *Regulation, Reimbursement, and Hospital Finances*. Final Report (Nashville, Tenn.: Vanderbilt University, Institute for Public Policy Studies, 1982).

"cap" the exemption of employer contributions, include the Reagan administration's plan introduced as S. 640 (98th Congress). Under this proposal all employer health insurance contributions in excess of a specified cap would be considered employee earnings, fully taxable by both the individual income tax and Social Security. The cap would differ between individual coverage and family coverage, and would be adjusted annually for changes in the consumer price index. Proposals of the second type, those that would eliminate all federal tax preferences for employer health insurance contributions, include the Bradley-Gephardt 1983 comprehensive tax reform bill (S. 1421/H.R. 3271, 98th Congress). The Bradley-Gephardt bill would require that all employer health insurance contributions be considered employee earnings and would raise the health expenditure floor for the individual income tax deduction to 10 percent of adjusted gross income.

The difference between proposals to modify tax preferences for employer health insurance contributions and proposals to altogether eliminate tax preferences for employer contributions is probably in the magnitude of effects rather than in the type of effect. The effects of these proposals fall into four general categories: (1) changes in the level of coverage provided by employer group plans; (2) changes in employer costs; (3) changes in the rate of private health insurance coverage among workers and their families; and (4) changes in tax revenues and the distribution of the tax burden. Each of these effects is discussed in turn.

Changes in the Level of Coverage Provided by Employer Group Plans—The most frequent argument for reducing or eliminating tax preferences for employer contributions to health insurance is the potential effect of taxation on the level (or completeness) of coverage provided by employer group plans. Advocates of reduced tax preferences cite the scarce literature on the relationship between prices and the level of insurance coverage, and the relatively abundant literature on the relationship between more complete coverage and higher health care costs. Based on this literature, they conclude that, since tax-exempt employer contributions encourage more complete insurance coverage and greater use of health care services, removal of tax exemptions will encourage less complete coverage and lower levels of health care use. Lower levels of health service use will, the argument concludes, reduce aggregate health care costs and ultimately dampen inflation in health care prices.

Advocates of maintaining tax preferences for employer health insurance contributions say that this argument is simplistic. It disregards, they say, the complexity of consumer demand for health insurance. In a multiproduct health service market with varying rates of cost inflation, consumer demand for insurance against the most rapidly inflating component is likely to be rigid. That component poses the greatest financial risk to consumers. Insurance offers consumers protection against that risk and further allows consumers (in a limited way) to hedge inflation. As a result, consumers would be reluctant to reduce coverage for the particular service category—hospital care—that drives inflation in health care costs.

Advocates of maintaining tax preferences contend that coverage of other service categories—primary physician care, preventive services, and routine dental and vision care—are more vulnerable to increases in the price of health insurance to consumers than hospital coverage is. The cost of these services, they observe, has been remarkably stable relative to the cost of hospital care. Moreover, they argue, greater use of primary and preventive care may reduce hospital use. Advocates of maintaining tax preferences conclude that revised tax policy, if successful at all, is probably an inefficient way to curb inflation in health care costs.

These arguments have not been satisfactorily resolved; neither position is based on a substantial body of research. To break the deadlock, other arguments that might support revising the tax treatment of employer health insurance contributions must be considered.

Changes in Employer Costs—Employer group health plans, as a rule, cover most if not all employees of a firm. Despite potentially wide variation in the health care risks represented by different employees, broad participation in the plan is achieved by keeping the price of coverage to employees low. The merged survey data on employer plan provisions between 1977 and 1980 reported in chapter II indicate that more than 80 percent of all plan participants make no contributions to their coverage under the plan; more than 60 percent make no contribution for dependents' coverage.

The pooling of risks within employer group plans can generate significant cross-subsidies among employees who participate in the plan. Low-risk employees (for example, young employees or employees with no history of chronic illness or impairment) receive benefits from the plan that may be considerably less than the employer's average cost of providing health insurance to them. Conversely, higher-risk employees (for example, older employees or employees with chronic health problems) may receive benefits in excess of the employer's average plan costs. Because low-risk employees pay little or none of the cost of the plan, however, they are indifferent to their subsidization of higher-risk participants in the health plan.

Taxation of employer contributions to health insurance would raise the cost of coverage to participants in employer group health plans. Low (that is, stringent) levels of a tax cap on employer contributions would create an incentive for low-risk employees to reduce their after-tax cost of health care by seeking less complete or less comprehensive health insurance coverage. The exit of low-risk participants from existing plans (adverse selection) would raise the average risk that plan stayers represent. As a result, the average cost of existing plans would rise.

Employers have objected to the proposed taxation of health insurance contributions because they expect taxation to significantly raise their costs of providing health insurance benefits. Increased employer costs might result in several ways. First, employer tax liability under the Social Security tax would rise. Because employer payments to Social Security are deductible under the corporation income tax, however, the net increase in employer tax liability is likely to be modest.

Second, employers expect that workers would respond to taxation of health insurance contributions by demanding higher cash wages, greater levels of alternative tax-exempt benefits, or higher employer contributions as a share of plan cost in an effort to maintain before-tax compensation levels.

The adverse selection of low-risk employees from existing plans, moreover, might generate a second-round increase in employee demand for greater before-tax compensation. As low-risk plan participants left the "standard" plan, the average cost of the plan—and employer contributions for the remaining participants—would rise. Employers anticipate substantial pressure from employees who benefit from generous plan coverage to continue to offer that coverage. As the average cost of "standard" coverage rises, however, equivalent compensation for employees who leave generous plans would also rise.

Third, because of pressure from some employees to offer less expensive alternative health insurance coverage, employers foresee increased administrative costs as well as the loss of economies of scale in their group plan benefits. The fragmenting of existing employer group plans into a number of smaller plans might increase insurance costs for smaller employers or reduce the coverage that employers are able to provide at current cost.

Changes in the Rate of Private Health Insurance Coverage—In the absence of reliable time-series data, no research has been undertaken that directly describes the effect of tax preferences on: (1) growth in employer health plan participation; or (2) the distribution of that growth among workers and their dependents. Estimates of the determinants of employer group health insurance coverage are relatively plentiful; that literature, however, holds little information about the distribution of coverage that might result if the structural basis of employee benefits were changed.

A study conducted by Lee[23] sheds light on the differences in the rate and distribution of coverage that might prevail without tax preferences for employer contributions. Lee compared the determinants of private health care coverage among persons living in households of employed and unemployed workers. His study provides, in effect, an approximation of the differences in coverage that emerge between persons who may purchase health insurance with before-tax dollars (employed persons) and persons able to purchase insurance only with after-tax dollars (unemployed persons). Lee's findings suggest that demand-related variables that are insignificant determinants of employer group coverage among persons living in employed-worker households (for example, family income, worker education, and worker race) become significant determinants of health insurance coverage among persons in unemployed-worker households. Conversely, variables that significantly determine the probability of employer coverage among employed workers (for example, number of children in the household and worker age) are not significant determinants of insurance coverage among persons in unemployed-worker households. These variables apparently reflect the worker's demand for employment that offers health insurance benefits or the supply of health benefits to more senior workers.

Lee's findings, based on coverage rates among households of unemployed workers, reflect household decisions made in an unstable, transitory setting and are of only limited use in suggesting the rate and distribution of coverage that might occur if tax incentives—and employer contributions to health coverage—were reduced. Nevertheless, they do suggest that the rate of insurance coverage among at least some segments of the population might vary substantially in the absence of tax-encouraged employer contributions. In particular, the relatively egalitarian supply of employer group coverage among employed workers may raise "normal" rates of health insurance coverage among lower-income, less-educated, or nonwhite households, as well as among households that include children or older adults.

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[23] James A. Lee, *Employment, Unemployment, and Health Insurance: Behavioral and Descriptive Analysis of Health Insurance Loss Due to Unemployment* (Cambridge, Mass.: Abt Associates, Inc., 1979).

Based on an EBRI simulation of health insurance coverage among worker households, this interpretation of Lee's findings appears valid. EBRI's simulation, using a restructured data file from the March 1980 Current Population Survey, indicates that the distribution of private health insurance coverage might shift significantly and predictably in the absence of the employer contributions that are encouraged by tax preferences.

To simulate the rate and distribution of health insurance coverage that might emerge in the absence of tax preferences for employer contributions, EBRI estimated the determinants of private health insurance coverage among members of worker families that received no employer contribution to health insurance coverage during 1979. These estimates were then applied to worker families that did receive an employer contribution to simulate the rate and distribution of private health insurance coverage that might have occurred if health insurance could be purchased only with after-tax dollars. (The ability to purchase health insurance only with after-tax dollars is equivalent to the removal of all tax preferences for employer contributions to health insurance.) This simulation indicated that the tax-exemption of employer contributions to health insurance significantly raises the rate of private health insurance coverage among some worker families. Low-income families, single-adult families (even where children are present), younger families, and families in which the primary earner experiences some unemployment all demonstrated significantly lower rates of health insurance coverage in the simulation. Table IV.3 summarizes these results.

EBRI's simulation results suggest that full taxation of employer contributions to health insurance might lower the total rate of private health insurance coverage among members of worker families by more than nine percentage points; nearly all the reduction in health insurance coverage would occur among members of middle- and low-income families. Further, the simulation suggests the number of persons served by Medicare and Medicaid—and the cost of these programs—is significantly reduced by employer contributions to health insurance among low-income families. Appendix B describes in greater detail these simulation results and the technical development of the simulation.

Changes in Tax Revenue and Burden—Estimates of new federal revenues that might result from the taxation of employer contributions to health insurance are invariably high. A Congressional study of the tax-exemption of specific forms or uses of income ranked the mag-

TABLE IV.3

Actual and Simulated Probability of Private Health Insurance among Workers and Members of Worker Families by Selected Characteristics, 1979 (Percents)

Family Characteristic	Probability of Private Health Insurance Coverage: Workers: Actual	Workers: Simulated	Workers: Change	Members of Worker Families: Actual	Members of Worker Families: Simulated	Members of Worker Families: Change
All Persons[a]	96.7	77.8	−18.9	93.1	84.1	−9.0
Family Income:						
$ 0– 7,499	97.5	11.1	−86.4	82.9	11.0	−71.9
7,500–14,999	95.9	40.2	−55.7	89.7	55.3	−34.4
15,000–19,999	97.4	74.4	−23.0	93.7	91.1	−2.6
20,000 or more	96.7	87.5	−9.2	94.4	92.4	−2.0
Age of Primary Earner:						
Less than 18	91.2	69.4	−21.8	66.4	23.5	−42.9
18–21	91.0	64.0	−27.0	86.9	47.4	−39.5
22–35	97.4	70.3	−27.1	94.3	77.9	−16.4
36–64	98.9	90.7	−8.2	93.1	92.4	−0.7
65 or over	91.1	61.1	−30.0	90.5	75.4	−15.1
Unemployment of Primary Earner:						
None	97.3	81.0	−16.3	93.3	87.1	−6.2
1–4 weeks	94.3	66.7	−27.6	92.9	65.3	−27.6
5–12 weeks	91.7	63.9	−27.8	90.5	63.9	−26.6
13 weeks or more	93.2	41.1	−52.1	89.8	32.1	−57.7
Spouse Present:						
Yes	97.3	90.2	−7.1	95.4	92.3	−2.2
No	95.0	42.2	−52.8	84.8	53.3	−31.5
Children Present:						
Yes	97.2	82.2	−15.0	94.1	85.3	−8.8
No	96.3	73.2	−23.1	91.5	81.8	−9.7
Medicaid/Medicare Eligible:						
Yes	90.4	38.1	−52.3	70.9	44.2	−26.7
No	97.1	79.9	−17.2	94.9	87.2	−7.7

Source: EBRI simulation of private health insurance coverage with full taxation of employer contributions to health insurance.

Note: Actual and simulated rates are among workers and members of their families that reported an employer contribution to coverage of any family member in 1979.

[a] Includes some persons with incomes less than zero in 1979.

nitude of potential tax revenues from eliminating the exclusion of employer health insurance contributions fourth among potential sources of new federal revenues.[24] Because continued growth in private health insurance costs is assumed, estimates of potential future revenues also rise significantly over time.

Using a simulation of federal tax liability among households sampled in the 1977 National Medical Care Expenditure Survey, the Congressional Budget Office (CBO) has estimated the federal revenues that might result from various "caps" placed on the tax exemption of employer contributions to health insurance.[25] For example, CBO estimates that new federal revenues of $4.6 billion might result from a low (that is, stringent) cap of $1,440 annually for family coverage and $576 for individual coverage effective in 1983. Based on assumptions of static coverage and continued growth in employer plan costs, CBO's projected estimates of potential federal revenues between 1983 and 1987 rise at an average annual rate of more than 30 percent.

. Although the estimated new revenues from the proposed taxation of employer health insurance contributions are substantial, the estimates themselves are fragile. Like all revenue projections, they are susceptible to the assumptions on which they are based; in addition, however, these revenue estimates are very sensitive to small differences in the exclusion limit proposed.

The primary assumptions underlying projected federal revenues from the taxation of employer contributions include: (1) the cost of health insurance coverage; (2) the rate of employer contributions as a percent of cost; and (3) the rate and distribution of health insurance coverage among worker households. The cost factor currently used by the U.S. Treasury for projecting health insurance premiums is an actuarial estimate that rises somewhat faster than the projected growth in the medical care component of the consumer price index. Both the rate of employer contributions and the rate of health insurance coverage are assumed to rise slowly (less than 1 percent annually) after the tax exclusion is reduced.[26]

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[24] U.S. Congress, Joint Economic Committee (Press Release, November 20, 1982), mimeo, table 2. Larger sources of foregone or deferred federal revenues identified in the report were: (1) the tax deferral of pension contributions and earnings ($24.4 billion in 1982, based on 1981 income levels); (2) the deductibility of mortgage interest on owner-occupied homes ($19.6 billion); and (3) the deductibility of nonbusiness state and local taxes other than on owner-occupied homes ($17.8 billion). The "revenue loss" from the exemption of employer health insurance contributions, by comparison, was estimated at $13.6 billion.

[25] U.S. Congress, Congressional Budget Office, "Containing Medical Care Costs Through Market Forces" (Washington, D.C., 1982).

Use of these assumptions probably introduces substantial error into the calculation of potential revenues. Virtually any other assumptions, however, would be equally hypothetical. The cost of private health insurance, for example, relies on the package of health insurance benefits offered by employers, reimbursement arrangements made with providers, and the shortfall of Medicare and Medicaid reimbursement relative to provider costs. All these factors are undergoing dramatic change. Researchers have not developed a method for accurately predicting the effects of these changes on employers' insurance costs, but clearly they will affect the ultimate yield of a tax on employers' contributions to health insurance. In any case, the future rate of increase in employer contributions cannot be calculated with precision, given a change in tax incentives.

Possibly of more interest than the level of potential revenues from a cap on the tax exemption of employer contributions is the sensitivity of revenue estimates to different caps. CBO's revenue projections indicate that a relatively small increase in the level of contributions from federal income and payroll taxes would produce a significant drop in revenues. Raising the cap by 9 percent—from $1,980/$792 (family coverage/individual coverage) to $2,160/$864—reduced estimated revenues by 22 percent (see table IV.4).

The sensitivity of these revenue estimates to modest adjustments in the proposed cap reflects the relatively narrow dollar range of employer contributions to health insurance and the weak relationship between the size of employer health insurance contributions and household income. Among all employer group health plan participants included in the National Medical Care Expenditures Survey, three-quarters of those with an employer contribution to individual coverage received a contribution between $100 and $500 in 1977. More than half of all plan participants with an employer contribution to family coverage received a contribution between $500 and $1,200 in 1977.[27] Because of the relatively narrow range of these contributions, modest adjustments to the level of a proposed cap can affect a significant proportion of all persons who receive an employer contribution to coverage.

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[26] The assumed annual exemption limit is $2,100 for family coverage and $840 for individual coverage, effective January 1, 1984. The projected growth of employer contributions and worker coverage is based on actuarial estimates.

[27] Gail R. Wilensky and Amy K. Taylor, "Tax Expenditures and Health Insurance: Limiting Employer-Paid Premiums," *Public Health Reports* (July/August, 1982), table 2.

TABLE IV.4

Sensitivity of Projected Federal Revenues to Selected Tax Exemption Limits, 1983

Proposed Annual Limit on Family/Individual Exemption	Projected Federal Revenue (Billions)[a]	Increase in Limit (Percent)	Decrease in Projected Revenue (Percent)
$1,440/$576	$4.6	—	—
1,620/ 648	3.7	12.5	19.6
1,800/ 720	2.9	11.1	21.6
1,980/ 792	2.3	10.0	20.7
2,160/ 864[b]	1.8	9.1	21.7

Source: U.S. Congress, Congressional Budget Office, "Containing Medical Care Costs Through Market Forces" (May 1982), p. 35.

[a] Includes revenues from both individual income and Social Security taxation of simulated employer contributions above the exemption limit in 1983. Social Security tax revenues represent about one-quarter of total projected tax revenues. Estimates assume full application of the exemption limit to collectively bargained and nonunion plans.

[b] Limits proposed in S.640 (98th Congress) are set at $2,100/$840 for family/individual coverage, effective January 1, 1984. This legislation would "grandfather" collectively bargained plans. Projected 1984 revenue, assuming application of the exemption limit to only about one-quarter of collectively bargained plans in 1984, is $2.4 billion (U.S. Department of the Treasury, unpublished estimate).

Employer contributions to health insurance are broadly distributed across households at most levels of income. In 1979, the rate of coverage among persons with family income above $15,000 was high (73 percent or more) and varied little by income (see table IV.5). More than 90 percent of all persons with employer group coverage, including persons in the very lowest income range, received an employer contribution to coverage. As a result, the distribution of employer contributions to health insurance coverage is very similar to the distribution of employer group coverage across the population, with little variation in the dollar amount received by families at different levels of income.

The distribution of the tax burden that would result from limiting the exemption of employer contributions to health insurance reflects the flat distribution of employer contributions to health insurance over most levels of family income. Because employer contributions are relatively constant at all income levels, they represent a larger percentage addition to family income at lower levels of income than at higher levels of income. As a result, limiting the exemption of employer contributions to health insurance tends to place a relatively

TABLE IV.5

Rates of Employer Group Coverage and Employer Contributions to Group Coverage among Nonelderly Persons by Family Income, 1979 (Percents)

Family Adjusted Gross Income[a]	Persons with Employer Group Coverage	Covered Persons with Employer Contribution	Persons with Employer Contribution	Distribution of All Persons with Employer Contribution
Loss[b]	3.1	80.0	2.5	0.3
$ 1–$4,999	11.6	85.3	9.9	2.2
5,000– 7,499	34.5	88.7	30.6	3.2
7,500– 9,999	47.8	90.5	43.2	4.4
10,000–14,999	63.0	92.1	58.0	13.0
15,000–19,999	75.6	92.6	70.0	16.8
20,000–24,999	81.8	94.4	77.2	16.7
25,000–29,999	83.2	94.8	78.9	14.2
30,000–34,999	84.8	94.8	80.4	9.8
35,000–39,999	84.4	94.9	80.1	6.1
40,000–49,999	83.1	94.5	78.5	6.8
50,000–59,999	82.8	92.8	76.8	4.0
60,000–74,999	76.0	91.3	69.4	1.7
75,000 and over	74.4	86.0	63.9	0.6
Total, All Persons	60.6	93.1	56.4	100.0

Source: EBRI tabulations of the March 1980 Current Population Survey (U.S. Department of Commerce, Bureau of the Census).

[a] Includes earnings, interest, dividends, other property income and pension income. Excludes income from public insurance and transfer programs.

[b] Includes some persons reporting no income in 1979.

heavy tax burden on families at lower levels of income. In general, the federal income tax structure is not sufficiently progressive to offset both the distribution of employer contributions and the regressivity of the Social Security tax on earnings.

Estimates of the tax burden that would result from limiting the exemption of employer contributions to health insurance are presented in table IV.6. These estimates, produced by CBO, indicate that the distribution of tax burden among all families would be only mildly progressive, and would be regressive among households with incomes above $30,000. The mild degree of progressivity among low-income households is due primarily to lower rates of employer group coverage among low-income persons with relatively fragmented work patterns.

Among households that would be affected by a cap on the exemption of employer contributions to health insurance, the tax burden would be severely regressive. As a proportion of income, persons at the lowest income levels (persons reporting less than $10,000) would pay more than six times the amount of additional tax than would persons with incomes over $50,000. The regressive impact of taxing employer contributions to health insurance is a major argument against proposals to limit the exemption of contributions at all but the very highest level. The argument for pursuing a high exemption limit is weak, however, since a high cap would affect only a small proportion of all households and would yield little additional federal revenue.[28]

Effectiveness of Tax Policy in Containing Health Care Costs

Although industry surveys indicate that many employers have recently raised plan deductibles and copayments, employer group plans have traditionally been generous. Coverage of hospital care, in particular, has traditionally involved little cost sharing on the part of insured workers and dependents. This pattern of generous coverage for hospital care emerged for many reasons; possibly the most important is simply the historical precedent established by hospital- and physician-owned Blue Cross and Blue Shield plans in the 1930s. Federal tax policy has not discouraged the emergence of generous health insurance plans. Nevertheless, empirical studies suggest that tax policy may have contributed relatively little to the development and growth of these plans.

Private insurance that requires little or no cost sharing by consumers of health care has probably raised the demand for health care services and contributed to inflation in health care costs. Nevertheless, the relative importance of private insurance as a source of demand and inflationary pressure in the health services market has been declining.

Hospital care is the most inflationary component of health care services. Since 1965, the proportion of all hospital care purchased

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[28] Some have argued for the progressivity of limiting the tax exemption of employer contributions to health insurance based on the share of total new revenues that would be paid by higher-income households. (See, for example, Jack A. Meyer and William R. Johnson, "Cost-Shifting in Health Care: An Economic Analysis," *Health Affairs* (Summer 1983), pp. 20–35.) This definition of tax progressivity is unusual. The standard definition of tax progressivity is the one used here: the income distribution of new tax liability as a share of individual household income. With respect to the proposed taxation of employer contributions to health insurance, the two definitions of tax progressivity give conflicting results.

TABLE IV.6

Distribution of Additional Annual Tax Burden of $1,800 Annual Exemption Limit in 1983 by Household Income

	All Households		Households Affected		
Annual Household Income[a]	Average Additional Taxes[b]	Percent of Income	Percent Affected by Limit	Average Additional Taxes	Percent of Income[c]
$ 0–$ 10,000	$ 3	0.05	2	$138	2.76
10,001– 15,000	14	0.11	9	168	1.34
15,001– 20,000	21	0.12	14	147	0.84
20,001– 30,000	44	0.18	23	191	0.76
30,001– 50,000	88	0.22	33	267	0.68
50,001–100,000	116	0.18	36	323	0.43
Over 100,000	108	0.08	27	403	0.40

Source: U.S. Congress, Congressional Budget Office, "Containing Medical Care Costs Through Market Forces" (May 1982), p. 36.

[a] Household income before taxes, but including cash transfer payments (e.g., Social Security benefits) projected to 1983.

[b] Includes both federal income tax and the employer's and employee's share of federal payroll taxes. About three-quarters of the tax burden results from federal income tax liability. State and local income taxes are excluded. Estimates assume that taxable excess contributions are ineligible for the medical expense deduction under the federal income tax.

[c] Calculated by EBRI at the midpoint of the income range.

with private insurance has fallen steadily. Since 1975, moreover, private consumers have paid an increasing share of most health care services, including hospital care, directly out of pocket. Between 1975 and 1982, the real burden of hospital care borne directly by patients rose by almost one-half (see table IV.7).

The most important source of expanding coverage and health service demand over the past two decades has been the public sector. Since 1967, the public sector has purchased more than a third of all personal health care and more than half of all hospital care. Most of the growth of public spending for personal health care is attributable to the growth of Medicare and Medicaid spending. Since 1980, these two programs have purchased more than 35 percent of all hospital care delivered in the United States each year.

The size of public-sector spending relative to privately insured spending for personal health care is important in considering the revision of federal tax policy toward private health insurance. In legislating the Medicare and Medicaid programs, Congress established a standard of access to comprehensive health insurance coverage across the population. Federal tax policy that would significantly

TABLE IV.7

Distribution of Expenditures for Hospital Care by Source of Payment, for Selected Years 1965–1982 (Percents)

	Private				Public		
Year	Total Private	Direct Payments by Patients	Health Insurance	Other	Total Public	Medicare and Medicaid	Other
1965	61.2	17.2	41.8	2.2	38.9	—	38.9
1970	47.2	10.0	35.8	1.4	52.9	26.3	26.6
1975	44.7	8.2	35.4	1.1	55.3	31.3	24.0
1978	45.6	8.6	35.8	1.2	54.4	33.6	20.9
1979	46.2	9.9	35.0	1.3	53.8	33.9	19.9
1980	45.9	10.0	33.5	1.5	54.1	35.3	18.8
1981	45.9	11.1	33.4	1.5	54.1	35.5	18.6
1982	46.9	12.1	33.1	1.6	53.1	35.5	17.6

Sources: Robert M. Gibson, Daniel R. Waldo and Katharine R. Levit, "National Health Expenditures, 1982," *Health Care Financing Review*, vol. 5, no. 1 (Fall 1983), pp. 7 and 12; Daniel R. Waldo and Robert M. Gibson, "National Health Expenditures, 1981," *Health Care Financing Review*, vol. 4, no. 1 (September 1982), pp. 24 and 27; and Daniel R. Waldo and Robert M. Gibson, "National Health Expenditures, 1980," *Health Care Financing Review*, vol. 3, no. 1 (September 1981), pp. 44–47.

Note: Figures may not add to totals because of rounding.

erage across the population. Federal tax policy that would significantly reduce the level of private health insurance coverage or jeopardize access to coverage among middle- and low-income persons would promote gross inequities between the general population and persons eligible for coverage through public programs. Moreover, federal policy that would reduce eligibility or coverage under Medicare or Medicaid is reasonable only if persons who lost public-program benefits were able to obtain health insurance coverage in the private sector. Reductions in both public-program benefits and private-sector incentives for health insurance coverage are hard to reconcile as coordinated federal policy.

The sheer size of public spending for personal health care suggests the importance of Medicare and Medicaid as independent sources of health care cost inflation. Despite efforts to curb the burgeoning costs of Medicare and Medicaid, these programs have supported much of the inflation in aggregate health care costs, and in hospital costs in particular. The average Medicare beneficiary spends far more for hospital care than privately insured persons spend. Over the most

TABLE IV.8

Estimated Amount and Annual Growth of Expenditures for Hospital Care per Insured Person by Selected Source of Payment, 1976–1980

	Private Health Insurance[a]	Medicare[b]	Medicaid[c]
Amount of Expenditures:		(Dollars per insured person)	
1976	$122	$486	$NA[d]
1977	134	540	NA
1978	149	687	315
1979	164	772	442
1980	181	926	495
Average, 1976–1980	150	682	417
Annual Growth of Expenditures:		(Percent)	
1976	18.4	3.2	NA
1977	9.8	11.1	NA
1978	11.2	27.2	13.6[e]
1979	10.1	12.4	40.3
1980	10.4	19.9	12.0
Average Annual Growth, 1976–1980	11.9	14.5	18.3

Sources: Daniel R. Waldo and Robert A. Gibson, "National Health Expenditures, 1981," *Health Care Financing Review*, vol. 4, no. 1 (September 1982), pp. 24 and 27; Daniel R. Waldo and Robert A. Gibson, "National Health Expenditures, 1980," *Health Care Financing Review*, vol. 3, no. 1 (September 1981), pp. 44–46· Health Insurance Association of America, *Source Book of Health Insurance Data, 1981–1982* (Washington, D.C., 1983), p. 12; and U.S. Department of Health and Human Services, Social Security Administration, *Social Security Bulletin: Annual Statistical Supplement, 1981* (Washington, D.C.), pp. 207 and 220.

[a] Private insurance expenditures per person insured for hospital care.

[b] Medicare expenditures per Medicare Part A enrollee.

[c] Medicaid expenditures per Medicaid recipient (unduplicated count) of any personal health care services, including hospital care.

[d] Published figures not available.

[e] Average annual compounded growth between 1975 and 1978.

recent five years for which data are available, per capita spending for hospital care among Medicare enrollees exceeded per capita spending among the privately insured population by more than 400 percent (see table IV.8). Although part of the discrepancy in per capita spending for hospital care is the result of differences in the insured populations, at least some of the difference is attributable to hospital practices that maximize Medicare and Medicaid reimbursements.

Possibly because of the success with which health care providers have attuned their practices to Medicare and Medicaid reimbursemer , these public programs have led inflation in hospital costs. Between 1976 and 1980, the rate of increase in average Medicare and Medicaid spending consistently exceeded the growth of privately insured spending for hospital care. During those years, average hospital costs among Medicare enrollees and Medicaid beneficiaries rose at average annual rates of 14 and 18 percent, respectively. In contrast, average private health insurance costs rose by less than 12 percent. It is unlikely that these persistent differences in per capita spending between public programs and the privately insured population are the result of qualitative changes in the covered populations.

Until spending by Medicare and Medicaid programs is successfully controlled, tax policy to reduce private-sector demand for health care may have little effect on aggregate health care costs. Inflation in per capita spending for hospital care among the privately insured population has slowed, despite first-dollar coverage of hospital care under most employer group plans. Tax policy that discourages comprehensive health insurance coverage may further slow the growth of privately insured spending. Further slowing of privately insured spending, however, cannot offset the inflationary impact of greater public spending for health care.

Senator **Bradley**. Dr. Enthoven, do you have any comment on this attempt to determine the behavior patterns of the 45 million who have health insurance now? Do you agree that 10 million would opt out?

Dr. **Enthoven**. These days the word "compulsory" is very unpopular, so we try to sugar-coat it and express it differently with expressions like "tax incentives" or "tax credits." But let's call a spade a spade: there needs to be a certain amount of compulsion in health insurance, because there is what economists call a "market failure." That is, if Mr. Aetna comes out with an average premium for the community—reflecting the average cost—some people who are healthy will say, "Gee, I'm not going to have medical bills that high, so I won't insure." And they will not buy insurance, and take a chance.

Senator **Bradley**. Lower risk.

Dr. **Enthoven**. Right, lower risks.

Also, some of them will take a free ride, and they will say, "Well, if I get sick, I'll show up at the hospital, and they will take care of me anyway."

The bad consequences of that of course are that then Aetna finds, "Gee, the healthy didn't insure; it's only the sick that insured," and the premiums go up through the overhead.

Mr. **Bailey**. If they are right and really healthy, they have not affected the cost at all.

Dr. **Enthoven**. Anyway, the premium tends to go up, and the market tends to break down. And that is why we have a very high concentration of people who are not insured among free-standing individuals who don't have a group that, in effect, makes insurance compulsory.

So what I am saying is that to get people insured you need to have some powerful incentive like a tax credit that motivates even healthy people to go ahead and buy health insurance. And the trouble is, of course, for 30 million Americans who have no private health insurance or Medicare or Medicaid, they don't belong to a group that provides it, and so they don't get it.

One minor problem I have with what Mr. Salisbury is saying is, that he refers to this as a matter of choices. I think many of the people who don't have health insurance don't have it because nobody will sell it to them.

I will tell you, if TWA didn't get me home tonight, because I belong to an HMO, my widow would have the right to go on buying our health insurance at the group rate; but if we were on Aetna, or any other typical traditional insurance plan, 30 days later she would be out of luck. And you would have taken away her tax break that supports the family's health insurance because she would have to pay for it. She would have to pay for the HMO dues out of net after-tax income. And if she weren't part of the HMO group, she would probably be out of luck altogether as far as health insurance is concerned.

So a lot of people just don't have the choice, and we need to reorganize things so that everybody has the subsidized opportunity to buy themselves a good quality health plan.

Senator **Bradley**. Thank you very much.

The **Chairman**. Dr. Enthoven, let me ask you this: 50 years ago or 40 years ago, had we compelled employers to provide health insurance for their retirees, we would probably not have Medicare today. That would be my guess.

We went into Medicare because millions of people over 65, retired, couldn't or didn't buy health insurance. And during their working years with their after-tax dollars, they didn't provide for retirement health insurance. And I think Senator Bradley is almost asking to prove a negative—how many people will opt out? Hard to tell, because almost all of them are covered if they are employed now. But why didn't people, with their after-tax dollars, buy retirement health insurance if they knew it was coming, they had seen their parents in hospitals? Why not?

Dr. **Enthoven**. You know, a lot of people just didn't have the opportunity; most people aren't like you and me, having a well-to-do employer, steadily employed by one employer over a long period of years. A lot of people are intermittingly employed, work for marginal industries, in and out of employment, they work for emplpoyers who don't provide health benefits and then they don't get the tax break. So we need some kind of consistent long-term financing plan that gives them both the incentive and the means, or the help, to get that insurance.

You take somebody who is a small farmer in Oregon, spends a few years doing some construction and cutting lumber, and this and that, and doesn't have a steady employer over the years. He probably wouldn't have had the opportunity to get employer-provided health insurance as a retiree. And when he gets to be old and says, "Gee, now I want to get health insurance," nobody wants to sell him health insurance; he is uninsurable.

The **Chairman**. Well, not at a price that he or she could afford to pay, in any event.

Dr. **Enthoven**. That's right. Yes.

The **Chairman**. Any other questions?

[No response.]

The **Chairman**. Thank you very much, gentlemen.

Now let's move on to Dorothy Walsh, Warran Braun, Robert Gill, and Robert Stone.

I would ask your consent to put a statement of the Public Employer Benefits Council on the subject of the 401(k) plans in the record.

[The statement follows:]

PEBC
PUBLIC EMPLOYER BENEFITS COUNCIL

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P. Daniel Demko
Executive Director

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July 19, 1985

STATEMENT OF
THE PUBLIC EMPLOYER BENEFITS COUNCIL
BEFORE THE COMMITTEE ON FINANCE
UNITED STATES SENATE

The members of Public Employer Benefits Council (the "Council") have serious concerns regarding the unfair impact that the proposed elimination for public employers of cash or deferred arrangements under Section 401(k) of the Internal Revenue Code ("Section 401(k) arrangements") would have on them and their employees.*

The Council is an organization which includes members representing 24 State governments, along with a large number of city and county governments across the nation, whose total employees number over 1,000,000. One of the Council's primary objectives is to monitor and comment on proposed legislation that affects employee benefits provided by the public sector.

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* The Council believes that many of the additional limitations on Section 401(k) arrangements and other employee benefits proposed in the President's plan are either unnecessary or unjustifiably difficult and expensive to administer. We believe that the problems raised by these limitations will be adequately brought to the attention of the Committee by interested parties in the private sector. Consequently, this statement concentrates exclusively on the one issue in the President's employee benefits proposals that uniquely affects public employers and their employees.

Chapter 14.06 of the President's Tax Reform Proposal to the Congress would prohibit public employers (states, cities, counties, etc.) from maintaining Section 401(k) arrangements. Employees in the private sector would continue to be allowed the benefits of Section 401(k) arrangements, albeit in a somewhat more limited form.

The Council strongly opposes the President's proposal because it would put public employers and their employees at an unfair disadvantage vis a vis the private sector. Under current law, both public and private employers are given the opportunity to establish Section 401(k) arrangements for their employees.* Contributions made on behalf of an employee to a Section 401(k) arrangement and any earnings on such contributions are not included in taxable income of the employee until actually paid. Thus, these arrangements encourage retirement savings by permitting employees to put away money on a pre-tax basis.

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* The Internal Revenue Service determined in General Counsel Memorandum 38283 that public employers can maintain Section 401(k) arrangements, and it has issued several determination letters approving Section 401(k) arrangements established by public employers.

In addition to Section 401(k) arrangements, under current law a limited amount of compensation (generally $7,500) can be deferred by an employee of a public employer through an eligible State deferred compensation plan established in accordance with and subject to the restrictions of Section 457 of the Code ("Section 457 plan"). Amounts deferred under a Section 457 plan are excluded from employee income in the year deferred.* Private sector employers, on the other hand, are allowed, under Title I of the Employee Retirement Income Security Act of 1974 to provide unlimited non-qualified deferred compensation arrangements for management or highly compensated employees. Compensation deferred under such arrangements is not included in the employee's taxable income nor is it deductible by the employer until actually paid.

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* In addition, employees of eligible governmental educational institutions are eligible to exclude contributions to annuity contracts established under Code Section 403(b) from current income. The amount deferred by an eligible individual for a Section 403(b) annuity contract directly reduces the amount which can be deferred pursuant to Section 457. For that reason, and because Section 403(b) plans are only available to a limited number of public employees, this statement will not seperately discuss Section 403(b).

The President's proposal to deny public employees the benefits of Section 401(k) arrangements is based on the faulty premise that those employees should not be allowed to defer compensation under Section 401(k) arrangements since the availability of Section 457 results in "inappropriately duplicative" benefits. As discussed more fully below, Section 401(k) arrangements are superior to Section 457 plans for purposes of promoting voluntary retirement savings by employees. Moreover, as a practical matter Section 457 does not result in "duplicate" deferrals by public sector employees (e.g. excessive deferral of income under both Section 401(k) and Section 457) to any significantly greater extent than permitted in the private sector.

Section 401(k) Arrangements and Section 457 Plans Are Not Comparable

The policy basis underlying the favorable tax treatment currently afforded Section 401(k) arrangements is that they encourage voluntary retirement savings. These savings result in a better quality of life for participants during their retirement years and reduce dependence on Social Security benefits and on already strained defined benefit pension plans. In order to promote retirement savings by all employees (not just the highly compensated), special nondiscrimination tests were imposed under Section 401(k) which limit tax-favored deferrals by highly compensated employees on the basis of actual deferrals by lower-paid employees. These plans in operation have proven to be more effective in stimulating retirement savings by lower and middle income employees than either Section 457 or IRA's.*

Arguing that employees of public employers should do without Section 401(k) arrangements because such arrangements duplicate the benefits already available under Section 457 plans reflects a misunderstanding of the comparative effectiveness of Section 457 plans and Section 401(k) arrangements as vehicles for promoting retirement security. As demonstrated in the attached exhibit, the incentives for retirement saving provided under Section 401(k) arrangements are superior to those provided by Section 457 plans, even if Section 401(k) is restricted as proposed in the President's plan. Significantly, Section 457 plans are not funded by a trust whose assets are dedicated to the benefit of employees who have deferred compensation under the plan. Rather, deferred amounts are subject to the general creditors of the employer and need not be funded at all. In addition, employee access to funds deferred under Section 457 plans is more restricted. Loans are not permitted and distributions may not be made available to the employee except upon separation from service or in unusual circumstances. Moreover, rollovers to IRA's or private industry plans are not permitted from Section 457 plans, which significantly restricts the employee's flexibility in dealing with his or her retirement savings. All of these factors, along with the others noted in the exhibit, have the effect of reducing the amount employees are able or willing to contribute and therefore the effectiveness of Section 457 relative to Section 401(k) as a vehicle for promoting voluntary retirement saving.*

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* A recent survey conducted by the Employee Benefit Research Institute indicates that employees earning less than $50,000 are significantly more likely to utilize a Section 401(k) arrangement than an IRA. In addition, participation levels in statewide Section 457 plans range from 1.4% to 29% of eligible employees versus 60% or more for Section 401(k) arrangements.

Thus, Section 457 plans are not a substitute for Section 401(k) arrangements. To the contrary, they more closely resemble non-qualified deferred compensation arrangements currently available to the private sector.

In that regard, it is important to note that both Section 457 and Section 401(k) were added by the Revenue Act of 1978. The legislative history of Section 457 indicates that it was not added as a substitute for Section 401(k). Section 457 was merely intended to limit deferrals by public employees under non-qualified deferred compensation arrangements, which had previously been unlimited. The concern was that since public employers, unlike private sector employers, do not receive any deduction for compensation paid, there is no incentive to limit deferrals. Consequently, limitations on deferrals were imposed with respect to public employers which were deemed unnecessary with respect to private employers.* See General Explanation of the Revenue Act of 1978, Joint Committee on Taxation Print 66-76, March 12, 1979.

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* Moreover, if the President's proposal to eliminate ten-year averaging for certain lump sum distributions from qualified plans is not adopted, Section 401(k) arrangements would have an additional significant advantage relative to Section 457 plans. If the President's proposed $8,000 limit on annual contributions to Section 401(k) arrangements is not enacted or is increased, there will be another major distinction between Section 401(k) arrangements and Section 457 plans.

Excessive Deferrals By Public Sector Employees Will Not Occur

While it is true that duplication (i.e., utilization of both Section 401(k) arrangements and Section 457 plans to defer arguably "excessive" amounts) is theoretically possible for public sector employees under current law, as a practical matter the extent of such duplication is negligible. Compensation levels of employees in the public sector generally fall within a relatively narrow range, with very few, if any, employees who would be considered highly compensated by private sector standards. The result is that in most instances public employees simply cannot afford to defer the maximum amount of compensation permitted under either Section 457 or Section 401(k), much less both.

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* Limitations on annual contributions to qualified plans on behalf of public employees were already imposed by Code Section 415.

Larger contributions generally are made only by the relatively small number of highly compensated public employees, whose counterparts in private industry can participate in unfunded deferred compensation plans. Thus, to the extent Section 457 provides public employees with the opportunity to defer income on a pre-tax basis under more than one plan, the extent of such duplication is generally no greater, as a practical matter, than that which is available to private sector employees. In many instances it may actually be less because of the limits on contributions to Section 457 plans.

The Appropriate Way to Deal With Duplication

Even if one were to assume that a certain amount of excess deferral occurs when both Section 401(k) arrangements and Section 457 plans are made available to public sector employees (a proposition which the Council strongly disputes as outlined above), the remedy suggested in the President's plan for dealing with that problem is inappropriate. The complete elimination of a favorable employee benefit merely because a less attractive alternative is also available would put public employees at a disadvantage with respect to their counterparts in the private sector.

If Congress were to conclude that Section 457 and Section 401(k) provide duplicative benefits, the appropriate method of eliminating that duplication would be to offset the maximum contributions permitted under Section 457 plans (and Section 403(b) annuity contracts) by contributions actually made under Section 401(k) arrangements. The mechanism could be similar to the offset against the Section 457 limitations currently applied to contributions under Code Section 403(b). See Code Section 457(c)(2). Thus, for example, if the President's proposed $8,000 annual limit on contributions to Section 401(k) arrangements were enacted, a public employee making a $3,000 contribution to a Section 401(k) arrangement would have the maximum amount which he could contribute to a Section 457 plan (generally $7,500 under current law) reduced by $3,000, to $4,500.

There is no logical policy basis for discriminating against public employers and their employees by depriving them of Section 401(k) arrangements, which are available to the private sector. If duplication is determined to be something that must be addressed, the adoption of an offset is the only reasonable way to deal with it.

Conclusion

The President's proposal is not equitable to public employers and their employees and should be modified. Although the Council believes that allowing public employers to maintain both Section 457 plans and Section 401(k) arrangements would not put their employees in any better position than the private sector, any perceived duplication should be dealt with by offsetting the permissible contributions under Section 457 plans (and Section 403(b) annuity contracts) by any contributions actually made under Section 401(k) arrangements, not through the complete prohibition of Section 401(k) arrangements for public employers.

SECTION 401(k) ARRANGEMENTS VERSUS SECTION 457 PLANS

Feature	Section 401(k), as proposed under the President's Plan	Section 457
Funding	Amounts deferred and earnings thereon are held in trust solely for the benefit of the employee.	Amounts deferred and earnings thereon remain subject to the claims of general creditors of the employer.
Discrimination Testing	Discrimination testing imposed, resulting in higher participation by lower-paid employees.	No discrimination testing is imposed.
In Service Access to Contributions	Loans are permissible. In service distributions will not result in plan disqualification. Rather, a recapture tax of 10% or 20% is imposed on employees.	Inability to access funds, even in emergency, is a significant deterrent to participation. Loans are not permitted. Early withdrawal for reason other than "unforseeable emergency" would result in failure of plan to be eligible for Section 457 treatment.
Taxation Of Distributions	Tax-free rollover into another qualified plan or an IRA.	Rollover to other Section 457 plans permitted only under certain conditions and without employee discretion. Rollover to private industry qualified plans or IRA not permitted.
Contribution Limits	Lesser of 20% of compensation or $8,000 minus any IRA contributions.	Lesser or $7,500 or 33 1/3% of compensation. Subject to limited "catch-up" during three years prior to normal retirement age.
Earnings	The employee is entitled to earnings on deferred funds, and a wide variety of investment options can be offerred.	Since there is no funding requirement, the employee only receives earnings if contributions are actually made and invested.
Investment	Employees can be given wide investment choices.	Since deferred amounts remain assets of the employer, employee control over investment may be restricted by constitutional or statutory limits on investments by the State or its subdivision.

Mr. CHAIRMAN. Senator Matsunaga?

Senator MATSUNAGA. Mr. Chairman, before the panel begins I wish to submit a statement of the Small Business Council of America and request unanimous consent that it be submitted in the hearing record.

The CHAIRMAN. Without objection.

Senator MATSUNAGA. Mr. Chairman, the Small Business Council of America is a nonprofit organization which represents over 1,500 small business organizations on Federal tax matters. The statement is also endorsed by the Small Business Legislative Council, which is a Washington-based coalition of nearly 90 trade and professional associations representing more than 4 million small businesses. The statement is in essence the same one delivered before the House Ways and Means Committee by Mr. Morton Harris from Columbus, GA, president of the Small Business Council of America.

May I add, Mr. Chairman, that there is a very strong local chapter of the Small Business Council of America in Hawaii which serves as an invaluable resource for those of us who must grapple with tax issues before Congress. The statement of the Small Business Council of America, endorsed by the Small Business Legislative Council, poignantly outlines the impact on small business which would result from the President's tax reform proposal on employee benefits. I urge its perusal by every concerned member of this committee before making any decisions.

The CHAIRMAN. Thank you.

Ms. Walsh.

[The statement of the Small Business Council of America follows:]

STATEMENT OF

MORTON A. HARRIS

PRESIDENT

SMALL BUSINESS COUNCIL OF AMERICA, INC.

AND ON BEHALF OF THE

SMALL BUSINESS LEGISLATIVE COUNCIL

ON

THE EFFECT OF PRESIDENT REAGAN'S PROPOSALS FOR COMPREHENSIVE TAX REFORM ON EMPLOYEE BENEFIT PROGRAMS

BEFORE THE

COMMITTEE ON FINANCE
U. S. SENATE
SD-219
SENATE DIRKSEN OFFICE BUILDING

JULY 19, 1985

INTRODUCTION

The Small Business Council of America, Inc. ("SBCA") is a non-profit organization which represents the interests of small business organizations on Federal tax matters. SBCA has a membership of over 1,500 consisting of successful retail, manufacturing and service organizations located in 47 states, most of which maintain employee benefit plans qualified under I.R.C. §401(a). SBCA's leadership consists of a large number of tax attorneys, accountants, actuaries, consultants and bankers who specialize in employee benefits, who in turn represent in excess of 50,000 small business organizations which sponsor qualified retirement plans. Consequently, SBCA represents the interests of a great number of organizations and their employees across the country who have a significant stake in legislation which affects the structure, implementation, and operation of qualified retirement plans.

The Small Business Legislative Council (SBLC), on whose behalf this statement is also made, has as its membership over 90 business and trade associations (including the SBCA) which have as their members over 4 1/2 Million small businesses.

IN GENERAL

In recent years, frequently changing legislation in the qualified plan area has been particularly disruptive to the plans of small companies. In addition, the legislative bias against small plans has been only thinly veiled, and in one instance not veiled at all, i.e., the "Top-Heavy" rules which were introduced, without prior hearings or advance public announcement, during the deliberations of the Congressional Conference Committee on TEFRA.

For many small plans, the costs and complexities of pension design and administration and the costs of frequent plan amendments have literally gotten out of hand, making qualified retirement plans unattractive to many small businesses because they are no longer cost effective.

The private pension system, so essential to the retirement well-being of millions of American families, and, for that reason, critical to the solvency of the Social Security system, has been so over-regulated during the past 12 years, that it is already beginning to fall of its own weight. This statement is not a cry of "wolf." Government statistics show the recent substantial increase in plan terminations (running at over 50% of the level of new plan formations), with the impact of the three major pension law changes (any change which causes an amendment to a small plan is a "major" change) during the past 35 months, i.e., TEFRA, DEFRA and REA, only just beginning to surface. Information recently furnished by the Small Business Administration (SBA) states "...increased administration costs and heavy withdrawal penalties have increased plan terminations by small businesses that can least afford these costs." So complex are the system's workings, that they are now well understood by only a relatively few experts; and any nationwide program meant for use in administering approximately 750,000 qualified employee retirement plans which benefit over 50 million participants cannot effectively be maintained by such a small number of advisors. What is even more troublesome, however, is that the costs to the plan sponsor of repeated plan revisions (three required revisions in the last three years) and the costs to the plan sponsor for plan administration have risen so significantly during the past decade that massive plan terminations are already guaranteed during the next few years, and an untold number of new plans will never be established. This is confirmed by several sources including a report provided by the Small Business Administration (SBA) which shows that between 1979 and 1983 the proportion of workers in small firms with fewer than 25 employees making contributions to their pension plans decreased from 20.2% to 18.7%, as compared to no significant change in larger plans.

During the months since TEFRA many small business owners have openly questioned whether the extinction of small business sponsored pension plans is the object, or merely an unintended consequence, of Congressional policies? The President has characterized, as the goal of his Tax Proposals, "...an America bursting with opportunity." This is the age of the entrepreneur, he said. He heralded "the small but growing circle of heroes, the small business people, American entrepreneurs, the men and women of faith, intellect and daring who take great risks. . . ." He proposes to motivate this group by lowering personal and corporate tax rates, and reducing capital gains taxes. We submit that an equally realistic motivator for the typical individual contemplating starting his own business is the opportunity (once the business is successful) to create a retirement fund for himself and his family. Few individuals can, as a practical matter, look to a sale of their businesses. They all can, however, look to building those businesses into sources of income for use during their working lives and retirement years.

This is where the private pension system plays a part. Not only does the system help bring forth this entrepreneurial spirit, but also it helps to secure a solid retirement for the entrepreneurs and their employees. The object of our tax policy, then, should be to encourage the adoption and maintenance of qualified retirement plans in greater numbers than ever. However, if one looks at the legislative record during this decade, it can be understood why one might question whether the opposite may have been our National policy. We have had, since the passage of ERISA in 1974, the enactment of a succession of laws which have added enormous complexity and escalated plan administration costs, while at the same time diminishing benefits of privately sponsored retirement plans, the results of which threaten to put an end to the private pension system. Sometimes these legislative changes have been in the name of "revenue enhancement," sometimes "deficit reduction," and sometimes "fairness" or "tax equity"; however, whatever the stated rationale, the result is the same, less benefits to those in control of the businesses which adopt or maintain the retirement plans and greater costs for (1) plan administration (e.g., reporting and disclosure in the operation of plans and plan benefit distributions) and (2) the almost annual requirements for costly plan amendments.

It is important to recognize that according to statistics developed by the Office of the Management and Budget in 1980, qualified retirement plans sponsored by small businesses (under 25 participants) cover more than six and one-half million (6,500,000) employees. These small plans (which represent almost 90% of all plans) are maintained by small business at significant expense, with the plan administration costs for small plans often running at a level which is ten (10) times higher on a per participant basis than for larger plans.

As stated above, commencing in 1974 with ERISA, small plans have been the subject of major legislative changes by TEFRA, DEFRA and REA, each law requiring additional amendments to all qualified plans in the country. It should be especially noted that the pension provisions of TEFRA which created new Code §416 (the "Top-Heavy" Rules) must be listed high among the most discriminatory laws ever passed by the Congress.[1] It singles out qualified retirement plans sponsored by small business for numerous burdens and costs not applicable to larger plans. As a result, the very group least able to absorb these costs has been required to substantially amend their plans to incorporate these rules which compress plan benefits and increase company costs.[2]

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[1] The "Top-Heavy" rules appear to be the only rules that openly discriminate against small business to be found anywhere in the Internal Revenue Code.

The reason for this digression to TEFRA is that in many instances the President's proposals regarding pensions would also impact small plans far more negatively than mid-size or large plans. It is ironic that "small business" and the entrepreneurs who own them, though apparently appreciated and often loudly praised by lawmakers, unfortunately become the "poor cousins" when specific legislation is considered. Sadly, at the very time a fourth major pension law change (which will again require substantial amendments to existing plans) is being proposed, the Employee Benefit Research Institute (EBRI) has found, based on a nationwide survey (sponsored by EBRI and the U. S. Department of Health and Human Services) in May 1983, that small companies with fewer than 100 employees are less likely to provide qualified retirement plans than larger companies. The report also shows that between 1979 and 1983, the coverage rate of these small plans fell from 61% to 56%. This is consistent with the information furnished by The Small Business Administration and with a recent report by the U.S. Department of Labor which states that while 80% of workers in medium and large firms have pension coverage only slightly more than 50% of all workers are covered by pensions. The EBRI study concludes that if small companies could be encouraged (through tax incentives) to sponsor retirement plans at the same level as companies with 100 to 500 workers, then approximately 7.6 million additional employees would be covered by qualified retirement plans. It is imperative that Congress recognize that under the present legislative environment such growth will never take place. In fact, the opposite is already occurring and will continue to occur until first, the law becomes stable for a reasonable period of time, and second, small qualified retirement plans are treated no more restrictively than larger plans rather than being singled out for discriminatory treatment.

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[2] A "Top-Heavy" retirement plan is synonymous with a small plan. By definition, a "Top-Heavy" plan is one in which the value of the plan interests allocated for certain owners and highly compensated individuals is in excess of 60% of the value of the interests allocated for all plan participants. It is obvious that mathematically, the larger the employee pool for any given entity the easier it is not to be a Top-Heavy plan. Conversely, the smaller the employee pool, the easier it is to be "Top-Heavy." Because most small businesses have few employees, with the owner-employees often being the major portion of the employee staff of the small business and these plans are, therefore, almost always "Top-Heavy."

PRESIDENT'S PROPOSALS

IN GENERAL

In general, the proposals for changes in the pension laws are not simple (in fact add additional complexity), are not fair (in fact widen the gap in the conformity of treatment of large and small plans), and will not promote growth in the number of small plans (in fact will increase the number of terminations and inhibit the adoption of small plans).

MODIFICATION OF DEDUCTION RULES AND ANNUAL LIMITS ON CONTRIBUTIONS AND BENEFITS

The proposed modifications set forth in Chapter 14.03 of the proposals clearly do not follow the adage "If it ain't broke, don't fix it," there being no evidence that existing limitations on contributions and benefits are not working. In addition, in Chapter 14.04 the related proposal which abolishes the 1.25 limit for all plans other than small plans, states that the present law "imposes a significant burden on employers and plans, and indeed may be the primary source of complexity in the retirement plan area." At p. 356. Assuming the correctness of the statement, it is inconsistent that on one hand the proposal recognizes the complexity of these limitations for large plans while at the same time proposing that the complexity be kept for small plans and, in addition, recommends two new limitations and significant changes in two other existing pension rules.

Aside from this inconsistency, the Small Business Council of America feels it to be clearly unfair to abolish the overall "1.25 limit" as recommended in Chapter 14.04 for all plans other than small plans (i.e., top-heavy plans). The President's analysis is as follows:

> "Eliminating the overall limit for non-top-heavy plans would eliminate a significant source of complexity and thus would promote the adoption of tax-favored plans. It should also provide employers with a significant incentive to maintain both defined contribution plans and defined benefit plans." At p. 359.

This statement clearly states that importance of plans sponsored by large businesses being relieved of recognized complexity, but does not reflect this same concern for plans sponsored by small business which to a much greater extent should be given a workable incentive to sponsor both defined benefit and defined contribution plans for its employees. The rationale for this distinction simply cannot be discerned by SBCA.

The proposal in §14.03 also would impose an additional 10% tax on all benefits distributed to or with respect to a participant from all plans, including IRA's and tax sheltered annuities, which exceed 1.25 times the defined benefit dollar limit in effect for the year. Although this proposal sounds relatively simple, it should be carefully studied before it is incorporated into the pension system. Two issues immediately surface with respect to the operation of this provision: First, this proposal states that implementation of this section will not require significant employer involvement which assumes that plan distributions are primarily the responsibility of the employee. Whether this is a prudent assumption is not clear since many small plan sponsors determine, handle and often bear the costs of planning for plan distributions to participants. Statements in this proposal do acknowledge that employers simply cannot handle any more responsibilities in the retirement plan area; however, the fact that the proposals shift these responsibilities to employees as a satisfactory solution appears questionable. Second, it is not clear how these proposals would improve on the existing I.R.C. §415 limits in this regard. In many cases it appears that upon retirement, many participants whose plan benefits have been at all times within the §415 limits applicable to contributions or benefit accruals will, nevertheless, be subject to this additional tax. In fact, an employee may be forced to take a distribution in excess of 125% of the defined benefit amount in a given year due to the minimum distribution rules or because of personal hardship. Although it is well recognized that stability and certainty of the law is an essential element to a viable pension system, let alone a tax system generally, it is clear that under this proposal a plan participant because of the plan distribution requirements or an emergency may, at the eleventh hour, be faced with an additional 10% tax, notwithstanding he or she was at all times during plan participation years within the limits of the law. This places a premium on sophisticated (and costly) planning for plan distributions and penalizes participants who are faced with unexpected and unavoidable hardship.

REVISIONS OF §401(k) PROVISIONS

While SBCA recognizes in Chapter 14.06 an attempt to broaden coverage of I.R.C. §401(k) plans to more employees and, also, to limit percentage differentials between the highly compensated and other employees, SBCA is opposed to these proposals which make an already complicated area significantly more complicated (and more costly to administer) while, at the same time, restricting the level of benefits.

Specifically, SBCA is against limiting the §401(k) employee's elective contribution to $8,000.00, reduced by his or her IRA contributions. The §401(k) contribution should only be limited by the §415 limitation as presently provided.

In addition, the existing one-third/two-thirds mathematical test is much easier to deal with than the proposed "prohibited group member" test which would require employers to keep additional employee records and make continuous tests of the three year "look back" period. If the one-third/two-thirds test is not producing a proper non-discrimination result, then a one-fourth/three-fourths test could be adopted to accomplish the desired result with greater simplicity and efficiency. It remains critically important to note that for the sake of simplification, this test should be kept as a simple mathematical test based on current census data.

SBCA believes that different adjusted deferral percentages (ADP) will further complicate the area and once again introduce yet another element of uncertainty into our pension laws. There also appears to be no explained reason why the top compensated employees should not continue to average their ADP as is currently provided.

Further, SBCA believes that taxing "excess" employer matching and employee elective contributions to a §401(k) plan at a 10% rate will cause unnecessary additional administrative expenses in operating the plan and would typically function only as a penalty for inadvertent miscalculations in a very complex matter. SBCA suggests as an alternative that any "excess" employee elective or employer matching contributions should be distributed prior to the end of the plan year to which the contributions relate, with such required distributions not being treated as violating the existing distribution rules applicable to elective contributions or to qualified plans generally. Also, the distribution should be exempt from the early distribution recapture tax applicable to tax-favored plans. There does not appear to be any rationale for first imposing a 10% tax on excess contributions and then forcing a distribution, especially when excess contributions are almost always the result of administrative error in calculating the ADP percentages.

Further, SBCA opposes the proposal which would require plan coverage of employees after only one year of service. A §401(k) plan is simply a profit sharing or stock bonus plan with the addition of employee electives and the same eligibility requirements that apply to these plans under existing rules should apply to §401(k) plans.

Further, the deletion of "hardship" as a permissible event for allowing a distribution of employee elective contributions should not be promoted. Many employees will simply not put their own money into a plan if they know they cannot get to it in the event of a medical or other emergency.

If the proposals on §401(k) plans contained in Chapter 14.06 are put into law, it is clear that an entire new body of pension law and regulations will arise in the §401(k) area. It is disturbing that these proposals show no concern that tens of thousands of companies have established §401(k) plans for employees during the past four years (including, more recently, a large number of small companies) in reliance upon the law remaining stable. These proposals do not reflect full understanding that §401(k) plans entail significantly more administrative expense than required for other retirement plans, which is one of the reasons why §401(k) plans are not suitable for many small employers. For example, a great deal of communication with employees is required, and the plan administrator must make certain that payroll deductions are proper and notices of designated election periods are given to employees. Under these proposals the whole structure would have to be revamped (after only recently being put into place) at significant cost to employers. It is simply not fair to these companies or their employees to have this relatively new law so drastically rewritten. This is a particularly appealing area for Congress to express its recognition that certainty in the law is the keystone of retirement plans by preventing yet another expensive change from taking place.

MODIFICATION OF NON-DISCRIMINATORY COVERAGE

SBCA strongly opposes the 125% non-discrimination test proposed in Chapter 14.09 on the grounds that it is (1) extraordinarily complicated; (2) requires maintenance of employee records for a three year period to determine prohibited group members; and (3) is unnecessarily burdensome, particularly to small plans. SBCA suggests that if the purpose of these provisions is to remove the present nondiscriminatory coverage test (commonly referred to as the reasonable cross-section test) and to reduce the three year wait to a two year wait, then accomplish these goals without the laborious proposals contained in this Chapter. The present 70/80 test of §410 is a satisfactory test and has withstood the test of a very long period of time. It is now clear to most professionals who are in day to day contact with the operation and administration of small retirement plans that the retirement plan system, especially in the small plan area, is collapsing from the onslaught of recent legislation. These proposals can serve only to hasten the demise of the system and will certainly not add to the coverage of additional employees.

There is also an obvious question in these proposals, i.e., how do they apply in the context of a one participant plan? Literally, the proposed test would not work in a plan covering only one prohibited group member, e.g., a sales representative, architect, entertainer, etc.

CONCLUSION

After struggling to cope with ERISA, TEFRA, DEFRA and REA, the small business community cannot help but feel their retirement plans exist in an openly hostile environment. SBCA believes that many small businesses which have maintained their plans in spite of all the administrative and economic obstacles will consider yet another revamping and "improvement" of the present pension system as the "last straw" in forcing them to terminate their plans. The effect of these terminations will not only hurt the small business owners in their retirement planning but will also hurt many of the approximate 6½ million participants now covered by small plans.

The private pension system has for well over 40 years functioned in large part because of tax incentives. Small businesses, however, will not continue to maintain their plans or adopt new ones if they must absorb more administrative costs due to complexity and constantly shifting pension laws, particularly in light of the already discriminatory restrictions on small business plans. It is clear that if the "cost" of adopting or maintaining a qualified retirement plan is too great in comparison to the "benefits" to be received, the vast majority of the entrepreneurs (who make the decision to adopt or maintain a retirement plan for themselves and their employees) will simply forego the "opportunity" to do so.

A sad but unquestionable result of the adoption of the President's Proposals which pertain to pensions is that (without arguing the substance of these proposals) a vast number of the small businesses will simply no longer incur any more costs to amend their plans again. The "bottom line" and unfortunate result is that many small business members will terminate their plans rather than bear the burden of another restatement.

STATEMENT BY DOROTHY WALSH, DIRECTOR, GOVERNMENT AFFAIRS, AMERICAN SOCIETY FOR TRAINING AND DEVELOPMENT, ALEXANDRIA, VA

Ms. WALSH. Thank you, Mr. Chairman.

I am Dorothy Walsh, director of government affairs for the American Society for Training and Development, a 50,000 member association of professionals who specialize in workplace training and human resource development. Organizations represented by ASTD members provide work for more than half of the Nation's employees.

We have considerable familiarity with section 127 of the Tax Code, the employee educational assistance provisions. We had the pleasure of working with you, Mr. Chairman, in 1978 when these provisions were added to the Revenue Act. Because of what we have learned about educational assistance, its contribution to tax simplification, fairness, and productivity, I am pleased to testify today in support of the President's proposal to both permanently extend the tax exclusion for educational assistance and also eliminate the current dollar limitation. At the same time, our members wish to express their concern with the complex and unworkable nondiscrimination rules that have been proposed.

We have just completed one of the most extensive surveys ever undertaken on educational assistance use. The data collected from the survey comes from a broad cross-section of industries and public and private employers. Responses ranged from organizations with 43 employees to organizations with more than 100,000. Total employment for responding organizations was 6.6 million.

Our survey tends to be in agreement with other national surveys and Government studies of tuition aid and adult education. Findings of our survey clearly reinforce the need to extend section 127 and demonstrate educational assistance programs are operating fairly and effectively.

The survey results indicate that educational assistance plans are widely used. For example, 97 percent of all responding employers have educational assistance plans.

Participants in educational assistance programs are primarily average employees—that is, the survey found that 72 percent of the participants earn less than $30,000 a year. In fact, lower paid employees are more likely to participate. Employees making less than $15,000 participate at almost twice the rate of those who earn over $50,000.

Respondents told us that many participants are in their first 5 years of employment.

The clear connection to productivity was reported; 96 percent of the respondents said that educational assistance was used for improving skills on the job; 55.4 percent said that educational assistance helps employees learn basic skills like literacy and writing.

Positive employer collaboration with educational insitutions was demonstrated. For example, 91 percent of the respondents cited the local community college as a provider of educational assistance. Employees take a variety of courses like word processing, computer literacy, business English, technical/vocational training.

We have attached tables to our written statement that give other examples of data gathered from our survey.

The findings of our survey provide solid evidence of the value of educational assistance to average Americans and its contribution to maintaining the Nation's competitive edge.

Section 127 also makes an important contribution to Tax Code simplification and fairness. For employers maintaining educational assistance plans, section 127 replaces IRS regulations that use a complicated five-part test to identify tax-free education expenses called job-related education aid. Prior to section 127's enactment in 1978, these rules regulations were a complex and confusing burden on everyone involved—employees, employers, and the IRS. These rules are not only confusing, they are also hardest on the lower paid. Quite simply, the rules are designed to tax education that helps an employee move up the career ladder. Without section 127, a disproportionate share of reimbursements to lower income employees would be taxable because not strictly job-related.

Unfortunately, employee educational assistance contribution to fairness and simplicity would be undermined by complicated and unworkable nondiscrimination rules that have been included in the President's proposal. In spite of section 127's excellent nondiscrimination record—our survey shows that educational assistance is currently weighted in favor of the lower to middle salary ranges—Treasury would, nonetheless, require employers to mathematically test each year the utilization of educational aid by employees. Not only is this burdensome, it also ignores the fact that educational assistance is a voluntary program. In addition, only degree-related education could be counted in applying the test. While this often unclear distinction would further complicate the test, more significantly it quite unfairly would not count vocational and basic skills training that are utilized primarily by lower paid employees.

Because of these problems and the complexity of the rules, we urge you to reject the proposed nondiscrimination rules and retain the current nondiscrimination rules and the current reporting requirements.

In summary, the employee educational assistance provisions have worked well for more than 6 years. we know of no abuse. We hear about success stories. ASTD, and more than 125 organizations of business, professional and trade groups, individual employers, unions, and educational institutions strongly support the President's proposal to permanently extend section 127. S. 558 introduced by Senator Moynihan also extends section 127 permanently. We urge the Finance Committee to include an extension in tax legislation this year.

Thank you.

The CHAIRMAN. Thank you.

Mr. Braun.

[Ms. Walsh's written testimony follows:]

STATEMENT OF

DOROTHY A. WALSH

GOVERNMENT AFFAIRS DIRECTOR

AMERICAN SOCIETY FOR TRAINING AND DEVELOPMENT

TESTIMONY SUPPORTING EMPLOYEE EDUCATIONAL ASSISTANCE

BEFORE THE

SENATE FINANCE COMMITTEE

July 19, 1985

SENATOR BOB PACKWOOD

CHAIRMAN

AMERICAN SOCIETY FOR TRAINING AND DEVELOPMENT

Testimony on Employee Educational Assistance

I am Dorothy Walsh, director of government affairs for the American Society for Training and Development, the world's largest membership organization for professionals who specialize in work place training and human resource development. Organizations represented by ASTD's nearly 50,000 national and local members provide work for more than half of the nation's work force from entry level youth to top management. Consequently, we have considerable familiarity with Section 127 of the tax code, the employee educational assistance provisions. Because of what we learned about Section 127's contribution to tax simplification, fairness and productivity, I am pleased to testify in support of the President's proposal to both permanently extend the tax exclusion for employee educational assistance, and eliminate the current dollar limitation. At the same time, our members want to express their concern over the complex and unworkable nondiscrimination rules that have been proposed.

Currently, Section 127 of the tax code allows employee educational assistance to be excluded from an employee's gross income up to $5,000 a year. This provision expires at the end of 1985.

Employee educational assistance allows employees to receive training and education courses for upgrading skills and learning new job responsibilities.

A typical example of educational assistance is an employer "tuition aid" program. When employees are reimbursed for tuition, the employees are not taxed on that reimbursement as income. Therefore, they are not discouraged from participating in employer-sponsored education by an increase in their taxes. The importance of the extension of this provision can be underscored by the fact that a competent, well-trained workforce is central to the economic vitality of our commercial and industrial sectors. The quickening pace of change in technology, the economy, workforce demographics, deregulation and new labor/management agreements are creating increased demands for workforce education. Employer-provided educational assistance is a time-tested means of helping to upgrade the skills of American workers--at a very lost cost. It is an incentive for enhancing productivity while helping workers to improve their job and career capabilities.

Study of Educational Assistance

ASTD has just completed one of the most extensive surveys ever undertaken on educational assistance use. The data collected from the survey comes from a broad cross-section of industries and public and private employers. The responses ranged from organizations with 43 employees to organizations with more than 100,000. A total of 1,000 survey forms were mailed in February and as of the March 29 cutoff, 319 employers had responded and, of these, 309 said they offered educational assistance to employees. Total employment by responding organizations is 6.6 million.

The findings of the survey clearly reinforce the need to extend Section 127, and demonstrate that educational assistance programs are operating fairly and effectively. The survey results indicate that educational assistance plans are widely used -- for example, 97% of all respondents have educational assistance plans and 96% of all employees are eligible to participate.

Participants in educational assistance programs are primarily average employees -- the survey found that 72% of the participants in educational assistance courses earn less than $30,000 per year. In fact, lower-paid employees are more likely to participate in educational assistance programs -- employees making less than $15,000 participate at a rate almost twice the amount for those who earn over $50,000, and participation rates generally decline as salary levels increase.

Small and medium-sized organizations made the greatest use of their educational assistance programs -- the highest participation rate (14%) was found in organizations with less than 500 employees. The average participation rate was 5.6%.

The clear connection to productivity was revealed -- 96% of the respondents said that educational assistance was used for improving skills on the job, and 54.4% of respondents said educational assistance helps employees learn basic skills like literacy and writing. The type of training supported by employer programs is indicated by the educational providers identified -- for example, 91% of the respondents cited local community colleges as a provider of educational assistance courses with employees taking a variety of courses including word processing, computer literacy, business English or technical vocational classes. (Tables are attached that provide more data from ASTD's recent educational assistance survey.)

The ASTD survey tends to be in agreement with other studies and national surveys on tuition aid. Available research from the federal government on adult education corresponds to our survey's results.

In summary, the responses received by the ASTD survey, as well as the information, brochures and other materials sent, show that educational assistance:

- Is offered by a broad and diverse cross section of employers.
- Is utilized by employees at different compensation levels with the highest concentration in the low-to-middle income ranges.
- Helps laid-off workers to obtain new skills.
- Allows employers to offer cost-effective programs for upgrading skills of employees.
- Encourages workers to keep up to date with new technological and industrial developments.

What if Employee Educational Assistance is allowed to expire?

The findings of the survey provide evidence of the value of educational assistance to average Americans and its contribution to maintaining the nation's competitive advantage. However, given the focus of current debate on tax reform, it is important to note the contribution to fairness and tax simplification that Section 127 makes. If Section 127 is not extended, employers would have to determine taxability of educational assistance based on pre-1979 IRS regulations that are confusing, complex, and discriminatory against lower and middle income employees. Employers would have a choice between withholding taxes on all educational assistance to employees, or undertaking the considerable burden (and tax risk) of determining on an individual basis, whether each course an employee takes meets a complex set of rules. Differences in interpretation of IRS regulations would lead to wide variations in the tax treatment of similar situations. The inevitable result would be to discourage employers from providing educational assistance, and to deter employee participation.

If Section 127 is allowed to expire, not only will lower-paid employees suffer from a discriminatory test for taxability, but many questions may arise about important education programs, including employer programs to retrain laid off employees, union/employer apprenticeship programs, and skill training furnished by the military. Under Section 162 rules that apply in the absence of Section 127, reimbursements for education expenses are taxable unless the expenses meet a five-part test for "job-relatedness."

Unfortunately the IRS rules defining job-related educational expenses are astonishingly complex. Consider the following example which is based on Revenue Ruling 76-61 which reflects the operation of the five-part test under the Section 162 rules:

Two accountants work in the tax department of the same large company. The company has suggested they take certain tax and other courses that will help them with their jobs and has offered to reimburse the tuition cost. Accountant A takes a series of tax courses from a business school; his expenses are probably job-related and nontaxable (i.e., exempt from FICA, FUTA and income taxes). Accountant B takes tax courses from a night law school. If the courses can be applied to a law degree, then the tuition reimbursements are generally taxable - since they may qualify him for a new profession. However, if the law school were unaccredited, the reimbursements would be tax-free.

The rules are filled with anomalies. Two secretaries may take the same word processing course, and because of small differences in their jobs, one may be taxed on the tuition, while the other is not. A receptionist taking the same course would almost certainly be taxed.

If Section 127 is allowed to expire, educational expenses which satisfy minimum educational requirements for current employment would not be deductible. An employee who takes basic skills courses would be taxed on the value of the education as a minimum requirement for employment. Deficient reading, writing and arithmetic are problems in today's work place. For example, an estimated 15 million adults holding jobs are functional illiterates, and 47 million adults are borderline illiterate. Literacy classes paid for by an employer would probably be taxable to employees because of IRS rules for individual education expenses.

The rules are not only confusing, they are also hardest on lower-paid employees. Quite simply, the rules are designed to tax education that helps an employee "move up the ladder." Because of this and other aspects of the rules, far more reimbursements to higher-paid employees would be nontaxable because job-related.

Section 127 was enacted in 1978 to end the burden on employers of sorting out which tuition reimbursements are and are not job-related. By running all tuition reimbursements through a Section 127 plan, all could be equally exempt from withholding. For thousands of companies and millions of employees the tax code is simpler with Section 127 than without it.

Some think that repealing this exclusion will somehow enhance the tax base. This is an incorrect and short-sighted view. Employers "pay the freight" for educational assistance because it pays off in workplace performance. When an employee learns new skills, the result is a higher return on the investment: (1) for the employer through a more productive work force; (2) for the employee in job satisfaction; and (3) for the IRS in additional taxes from employees who learn more advanced skills, thus making higher taxable wages.

Estimates of the number of employees receiving educational assistance from their employers range from 2-3 million to about 6-7 million (estimates from data gathered by the National Center for Education Statistics). We can take the lowest estimate of 2 million employees to make some economic assumptions. If an increase in knowledge and skill results in an increase of 2% in an average income of $17,000 from these two million workers, and if their collective tax bracket is about 20%, Treasury would collect $135 million in additional income taxes from people who are improving their economic well being through educational assistance programs.

In addition, for every one percent increase in unemployment, the cost to the Treasury is $30 billion in unemployment insurance, welfare support, loss of income taxes, etc. If employer-provided educational assistance helps only one percent of the two million recipients to stay off the unemployment roles for half a year, the savings to the government would amount to about $300 million. Thus, the likely economic benefits such as higher taxable wages, improved work force productivity and lower unemployment costs far outweigh the small revenue loss that Treasury estimates.

The present exclusion for employee educational assistance encourages employers to promote improvement of employees' skills and to strive for upward mobility in the work force. According to the ASTD survey and other data, educational assistance enhances upward mobility for broad cross-sections of employees--including minorities and unskilled--in small, medium, and large companies, public employers and non-profit organizations. Given its broad and fair distribution among classes of employees (in contrast to the tax rules for education before Section 127), educational assistance promotes the basic goals of both social policy and sound tax policy. As such, the employee educational assistance provisions achieve the Treasury Department's objective of treating as many similarly-situated workers as possible the same.

Even though employers offer educational assistance to a broad cross section of employees, and our data show that the highest participation rates are in the middle-to-lower paid ranges, some say that all employee benefits are of greater value to high-income employees. In the case of educational assistance, the value of education should not be measured solely in terms of the cost of that education. Educational assistance also has important effects in the work force in increased wages and productivity. To the lower-income employee, the opportunity to receive additional education could mean the start to a meaningful career ladder and higher income. If Section 127 is allowed to expire, lower-paid employees, with narrower job descriptions and less education, would have to pay tax on most, if not all, education they received.

Proposed Nondiscrimination Rules

Treasury's concern that the lower-paid continue to benefit presumably is behind the welter of nondiscrimination rules that is included in the President's proposal. At the outset, it is important to note that our survey shows the simpler, nondiscrimination rules currently in Section 127 effectively prevent discrimination. Indeed, educational assistance is currently weighted toward the lower-to-middle income ranges. Treasury would nonetheless require employers to mathematically test each year the utilization of educational assistance to employees. Not only is this burdensome, it ignores the fact that educational assistance is inherently a voluntary program -- a program that relies on employees' willingness to sacrifice their free time to participate. Unlike medical insurance, employers can't simply provide educational assistance on a group-wide basis.

Still, the nondiscrimination rules would apparently have employers attempt to force certain employees to take courses they do not want, in order to satisfy arbitrary utilization quotas. The problem is that Treasury's uniform test for nondiscrimination simple does not work with the special characteristics of educational assistance.

In addition, only degree-related education could be counted in applying the test. While this often unclear distinction would further complicate the test, more significantly, it quite unfairly would not count the vocational and basic skills' courses that are utilized primarily by lower-paid employees. This distorts the test and stacks the deck against employers who provide what is often the most useful and relevant education possible to their lower-paid employees.

Because of these problems and the complexity of the rules, we urge you to reject the proposed nondiscrimination rules and to retain the current rules which have proved effective and adequate.

Summary

The employee educational assistance provisions have worked well for more than six years. We know of no abuse; but we hear over and over again about Section 127 success stories and its special importance to average emplyees. ASTD and more than 125 organizations including business, trade and professional associations, individual employers, unions and educational institutions strongly support the President's proposal to permanently extend Section 127. And the President's recent

Commission on Industrial Competitiveness recommended that Section 127 be extended permanently. S. 558 introduced by Senator Moynihan with 18 cosponsors including Senators Symms, Heinz, Grassley, Boren, Matsunaga, and Pryor also permanently extends employee educational assistance provisions. In addition, the Kemp-Kasten proposal (S. 325) allows educational assistance to remain tax-free. We urge the Senate Finance Committee to include an extension of employee educational assistance in tax legislation before Section 127 expires in December.

Table 1

Percent of Respondents Offering Educational Assistance Programs by Type of Industry and Total Employment

Type of Industry	Number Responding	Total Employment	Percent with Educational Assistance
Agriculture, Forestry and Fishing	4	53,845	100%
Mining and Construction	6	13,031	83
Manufacturing	133	3,921,434	100
Transportation	11	260,364	91
Communications	20	1,214,826	100
Public Utility	17	135,531	100
Retail and Wholesale Trade	12	386,704	83
Finance, Accounting, and Banking	34	128,657	100
Insurance	13	154,308	100
Health, Hospitals, and Related	32	87,983	97
Government	24	218,513	87
Other (educational institutions, research institutes, consulting organizations, etc.)	13	33,736	85
Totals	319	6,609,932	97%

A broad cross section of employers offer educational assistance to employees.

Table 2

Percent of Responding Employers Offering Educational Assistance by Size of Employing Organization

Total number of Employees	Number of Organizations	Percent Offering Educational Assistance
Under 500	38	87%
500 to 999	33	97
1,000 to 2,999	79	99
3,000 to 9,999	57	98
10,000 to 24,999	36	100
25,000 and over	76	99
Totals¼	319	97%

Table 3

Percent of All Employees Eligible for Educational Assistance by Salary Level of Employees

Salary Level	Percent Eligible					Average Eligibility
	100%	75-99	50-74	25-49	24 or less	
Under $15,000	85.2%	8.0%	1.9%	1.9%	3.0%	94.2%
$15,000-29,999	88.3	7.8	2.0	0.6	1.3	96.8
$30,000-49,999	92.1	4.5	2.8	0.6	0.0	98.2
$50,000 and over	95.1	3.1	0.0	0.6	1.2	98.1
Not specified	73.9	17.4	4.3	2.2	2.2	93.4
Total for all organizations	89.1%	6.6%	1.9%	1.0%	1.4%	96.6%

NOTE: Some organizations reported less than 100% eligibility as new employees are often not eligible and part-time staff may not be eligible.

Table 4

Rate at which Eligible Employees Participate in Educational Assistance Programs by Size of Organization and Salary Level of Employee

Salary Level	Under 500	500 to 999	1,000 to 2,999	3,000 to 9,999	10,000 to 24,999	.25,000 and over	Total by Salary Level
Less than $15,000	5.7%	14.7%	7.2%	8.7%	5.0%	6.6%	6.7%
$15,000 to 29,999	15.3	13.0	7.7	14.7	5.6	5.5	6.2
$30,000 to 49,999	12.8	17.1	7.5	14.6	7.6	6.7	7.5
$50,000 and over	8.3	14.6	2.8	3.7	1.7	3.8	3.8
Level not specified	14.2	13.0	10.2	7.0	5.1	5.0	5.2
Total by size of organization	14.4%	14.0%	8.1%	8.7%	5.3%	5.0%	5.6%

Lower-paid emploees participate in educational assistance programs at a greater percen n more highly-paid employees.

Table 5

Average Amount Spent on Educational Assistance by Size of Employing Organization

Number of Employees	Number of Respondents	Total Employment by Respondents	Total Spent on Educational Assistance	Average per Organization
Under 500	32	7,864	$ 579,871	$ 18,121
500-999	26	19,868	1,210,828	46,538
1,000-2,999	64	112,780	3,903,988	60,984
3,000-9,999	52	281,716	32,854,619	631,807
10,000-24,999	33	531,845	14,345,492	434,969
25,000 plus	51	4,322,852	108,312,701	2,123,764
Total	258	5,276,925	$161,207,499	$ 624,833

Table 6

What courses do employees take?

Educational Assistance stimulates productivity:

☐ 97.3% of all respondents said employees receiving educational assistance take some courses to improve their performance in their current jobs.
☐ 86.2% of all respondents said at least one-half of the courses directly improve employees' skills for their jobs.

Educational Assistance helps upward mobility of employees:
☐ 52.4% of all respondents said at least ¼ of all employees receiving educational aid take courses in basic educational skills. The category "basic skills" (e.g., reading, writing, math, GED, etc.) was cited by 54.8% of all respondents.
☐ Between 25% and 49% of employees participating in educational assistance take courses that could lead to a bachelor's degree, and thus a promotion, higher wages or expanded job responsibilities.

Educational Assistance encourages collaboration between employers and local community colleges:
☐ 42.7% of all respondents said at least ½ of all their employees receiving educational assistance take courses at local community or junior colleges.
☐ The category "community or junior college" was cited by 91.7% of all respondents. Employees take a variety of courses including word processing, computer literacy, business English or technical, vocational classes.

Educational Assistance is not used extensively for graduate school:
☐ 76% of all respondents said none of their employees receiving educational assistance take courses that could lead to a law degree. In all cases, of those respondents who allow employees to take legal courses, less than ¼ of all participating employees take legal courses.
☐ 50% of all respondents allowed courses that could lead to an MBA. These participating employees, however, take less than 24% of all courses allowed. Only 7 of 309 respondents said more than 50% of participating employees take courses that could lead to an MBA.
☐ Less than 5% of participating employees receive educational assistance for other graduate-level courses (e.g., engineering).

Employers follow Internal Revenue Service guidelines:
☐ 94% of all respondents prohibited sports, games or hobby courses. To the extent sports-type courses were allowed, the classes tended to be either fulfillment of degree requirements or directly connected to company product lines.

Table 7

Adult Education Data

1981	National Center for Education Statistics Data
	5.1 million participants in adult education take courses paid for by the employer (job-related and nonjob-related courses). • Total adult education participants is 21.2 million • 54% of all adult education participants are women • 60% of all adult education courses are taken to advance in a job or get a job. • 12.2 million courses are taken with the employer as the source of payment. • 54.5% of all participants in adult education earn less than $25,000.

SOURCE: National Center for Education Statistics (U.S. Department of Education) *Participation in Adult Education*, 1981.

STATEMENT BY WARREN BRAUN, PRESIDENT, EMPLOYEE STOCK OWNERSHIP ASSOCIATION, AND PRESIDENT, COMSONICS, INC., HARRISONBURG, VA

Mr. **Braun**. Mr. Chairman, members of the Senate Finance Committee, especially Senator Long, I am Warren Braun, president of the Employees Stock Ownership Association, and president of Comsonics, Inc., an ESOP company.

The ESOP Association supports the goals of fairness, growth, and simplicity in the Tax Code; however, we believe the best way to assure these goals for American employers is to retain the current tax laws on employee benefit plans, especially the existing tax treatment for employee stock in all plans.

Since 1974 the employee stock ownership has been favored by Congress, and many of you gentlemen, especially Senator Long, have significantly aided the movement, especially in the 1984 bill. These actions have resulted in over 6,000 ESOP plans being established in the United States. Why should 10 years of deliberation and legislation, with positive results, be scuttled in one summer?

Chapter 14 and subchapter 12.06 of the Treasury proposal would effectively repeal much of the work of Congress, and it would also repeal many of the plans, investment, and commitments made to employees by the private sector since 1974. All of these chapters should be rejected.

The ESOP Association statement of principles on this matter has been submitted with my written testimony.

May I introduce our company? Comsonics Inc., is a technical services and products corporation serving the cable television industry. We started our company in 1972, and after our rather feeble growth started our implementation of the ESOP in 1974. Since that date, we have grown 1,240 percent and have been selected by Inc. magazine as one of the 500 fastest-growing companies in the United States. Further, this year the company received the U.S. Productivity Medal for the State of Virginia.

In 1975 we had 29 employees; today we have over 120. In 1975 we paid $5,667 in Federal income taxes. This year we will pay in excess of $100,000, including the deduction for our ESOP contribution.

Our employees already own 48.5 percent of our corporate common voting stock. In another 18 months our employees will own all of it. And even though our company is small, its growth has occurred during the ESOP years. Our employees already have earned a substantial equity of participation in the company.

The proposed legislation, unfortunately, discriminates against employees in an ESOP company like Comsonics, which on the outside there are the fat cats who have the opportunity to manipulate and maneuver stock using such devices as stock option plans. Now, when they make their trade-out for money, it comes out of the rate of capital gains under the proposed legislation at 17.5 percent.

The skinny cats, the average worker, finds himself with a tax, under the new law, of 60 percent. That certainly is not fair. That is terribly discriminatory.

Now, there is mounting evidence that is very favorable to ESOP's. Look at the proceedings of the White House Conference on

Productivity, the President's Commisssion on Industrial Competitiveness, the New York Exchange Study, and get a copy of the new book that is about to be released—and I do recommend that get your staff to get a chance to read it—that the National Center for Employee Ownership is due to have out in September. That is Corey Rosen's book, a marvelous book. And John Nesbith's new book. All point to the effectiveness of ESOP's.

At the very least, Mr. Chairman, no changes to tax favored retirement plans should be made until the Ways and Means Task Force on National Income Retirement Policy submits its report, and until the General Accounting Office completes its current study on ESOP's and, futhermore, until each of you have had the chance to analyze the real record of honest-to-goodness live ESOP companies.

Thank you.

The CHAIRMAN. Thank you very much. Mr. Gill?

[Mr. Braun's written testimony follows:]

A PAPER PRESENTED

TO THE

UNITED STATES SENATE
COMMITTEE ON FINANCE

FRIDAY, JULY 19, 1985

WASHINGTON, DC

BY

WARREN L. BRAUN, P.E.
PRESIDENT
COMSONICS, INC.
P.O. Box 1106
Harrisonburg, VA 22801
Telephone: (703) 434-5965

Mr. Chairman, members of the Senate Finance Committee....

I come before you today as President of the Employee Stock Ownership Association. I am also Chairman and Chief Executive Officer of ComSonics, Inc., an employee owned company.

For the committee's information, there is a rapidly growing population of ESOP companies in America today, numbering well over 6000.

The ESOP Association supports the President's goals of fairness, growth, and simplicity in the tax code. We, the members of the ESOP Association, believe the best way to assure those goals is to retain the current laws as they are for employee benefit plans, especially the existing tax treatment for employee stock in all plans.

Since 1974, employee stock ownership has been favored by Congress. Many of you gentlemen have significantly aided that movement especially with the 1984 bill. It is difficult for us to understand why ten years of deliberation and legislation should be thrown away in one summer.

Chapter 14 and Sub Chapter 12.06 of the Treasury proposal would effectively repeal much of the past ten years of Congressional effort, and further, it would destroy many of the plans, investments, and commitments already made to our employees over the past ten years. For this reason alone, these chapters should be rejected.

The ESOP Association has devoted much thought and effort to this matter and has developed a statement of principles which are provided in the annex to this written testimony.

As for my personal experience with employee stock ownership, may I introduce our corporation, ComSonics, Inc., which provides technical services and products for the cable television industry. Starting in 1972 after a slow start-up, it became an ESOP in 1975. Since that date, we have grown 1240% and have been selected by the INC. magazine as one of the 500 fastest growing companies in the United States. In addition, this year the company received the U.S. Senate Productivity Medal for the State of Virginia. We have had many media reporters visit our facility to determine the essence of the ESOP concept in action. A few reprints of those articles are attached for your perusal in the annex.

Three graduate schools of Business have studied our corporation, as had the National Center for Employee Ownership. The University of Virginia Undergraduate School of Business has done a special half-hour television program on our company detailing the ESOP success story, while the graduate school has done a case study on our organization which they use in their graduate school studies. The record speaks for itself. I cordially invite you to visit us personally so that you might see first hand what miracles have been wrought by this concept.

In 1975, we had 29 employees. Today, we have over 120. In 1975, we paid $5,667 in Federal Income taxes. This fiscal year, we will pay over $100,000 in Federal taxes. And yet, in this process, the employees have acquired 48.5% of the corporate common voting stock. Within 18 months, they will own all of it through the ESOP trust mechanism.

Even though our company is small, its growth has been fueled and propelled by the ESOP. The real growth occurred during the ESOP years. Turning to the proposed legislation, its provisions are highly discriminatory against employees in an ESOP company. Compare its provisions for an outside investor's stockholder to the ESOP stockholder.

		Pay Tax	Taxed As
A.	Outside Fat Cat Investor	When they sell	Capital Gains at 17 1/2%
B.	Inside Fat Cats Management (Stock Options)	" " "	" " " "
C.	Skinny Cats rank and file employees in an ESOP	Big Tax when they retire Forced to sell stock then	Pay on Market, not Cost Basis Ordinary Income - 35% + State Tax No Capital Gains No 10 year averaging

Under this proposal, those employees could have been taxed:

35%	
20%	Pre 59 1/2 years old
5%	Virginia State Tax
60%	of their career retirement funds!

This would be unfair and discriminatory.

There is a mounting body of evidence that ESOP's applied to healthy companies bring about new heights of productivity. This is clearly demonstrated by the proceedings of the White House Conference on Productivity, the President's Commission on Industrial Competitiveness, and the New York Stock Exchange study. There are two new books, one to be published in September by the National Center for Employee Ownership, and the second, John Naisbitt's new book, both of which recite the productivity gains uniquely available through ESOP's.

With the evidence now coming forth demonstrating productivity gains to be achieved through ESOP's, should we kill the incentive just when it has begun to bear fruit? It seems to us that this is shortsighted and counterproductive.

At the very least, no changes to tax favored retirement plans should be made, Mr. Chairman, until the Ways and Means Task Force on National income retirement policy submits its report and until the general accounting office completes its current study on ESOP's, and further, until each of you have a chance to analyze the real record of operating ESOP companies.

Thank you.

Respectfully Submitted
Warren L. Braun
Warren L. Braun, P.E.

WLB/kjm

EXHIBITS 1 - 17

The
Employee
Stock Ownership
Association

PROFILE

ComSonics®, INC.

P. O. Box 1106 Harrisonburg, Virginia 22801 (703) 434-5965
An Employee Owned Corporation

"To operate profitably in a Dynamic, Progressive, Growth Oriented, Employee-Owned Corporation in the Electronic and Communications industry within a framework of high ethical standards of conduct..." is the mission of ComSonics as stated by the employees of the company. Warren Braun, President and founder of ComSonics, did not write that mission, if fact, he did not attend the meeting where the "Roles and Missions" were written but he could not have put it better.

PROFITABLE!

According to *Inc.*magazine,ComSonics has maintained a phenomenal growth rate—over 269% in five years. When asked if the company was profitable, Mr. Braun replied, "You better believe we are." Growth has been very systematic and well planned. Growth is programmed into three phases. The three-year plan is factual—based on contracts, knowledge of prices, costs, and actual expenses; the five-year plan is a combination of facts and concepts; the seven-year plan is completely conceptual—based on where the company feels it should be.

Employees establish these three plans of operation and continually check their progress throughout the year. ComSonics's management by objective works to increase their profits. The employees closest to the problems originate the objectives and plans; "upper management coalesces these objectives so it is profitable for all," according to Braun's statement in an article on ComSonics done by the *Washington Post*. Management by objective is at two levels; the supervisory and managerial. Managers and officers meet in monthly sessions to evaluate company performance and analyze financial results. Supervisors meet monthly and then the two groups hold joint meetings. Braun does not attend any of these meetings. The plans are presented to him and his role is to mesh all the plans into the larger three-, five- and seven-year objectives.

Functions and finances are aligned at all levels and are an integral part of the management by objective process. Every employee, beginning with supervisors, learns to read and analyze a financial statement. Managers deal with the full corporate budget. Also beginning with supervisors, employees are computer literate.

While cable television is new to many areas of the country, ComSonics has been in the business of rehabilitating and reselling cable, satellite and other electronic equipment and instruments since 1972. The company is the outgrowth of Braun's engineering and acoustical consulting firm. The company also designs and develops cable systems and does feasibility studies for companies that are considering entering the cable TV business. Because the industry is so new, a large part of the company is inventing, researching, diagnosing and building new products for the industry.

DYNAMIC!

You only have to meet Warren Braun once to know that this man's enthusiasm, pride, and intelligence would make the difference at any company and would be infectious to all employees. If Mr. Braun were a football player, he would not only be quarterback, he would be team captain and probably head cheerleader.

After working in the broadcast industry as a radio station engineer and after designing and building six radio and television stations for other people, Mr. Braun had had his fill of the "I am the boss" management attitude and being shut out of owning any part of the stations he had designed and built. So when he began ComSonics, he looked for a new way to make ownership possible for his employees. Braun believes there is a dignity of ownership—a self appreciation that you are an owner. Ownership allows an individual to grow as a person and it frees the organization to grow. ESOPs have a "flexibility in the joints," that traditionally owned companies do not have. That flexibility has been experienced at ComSonics. They are currently non-leveraged but they have been leveraged. They have made the minimum contribution, but they have also made the maximum contribution.

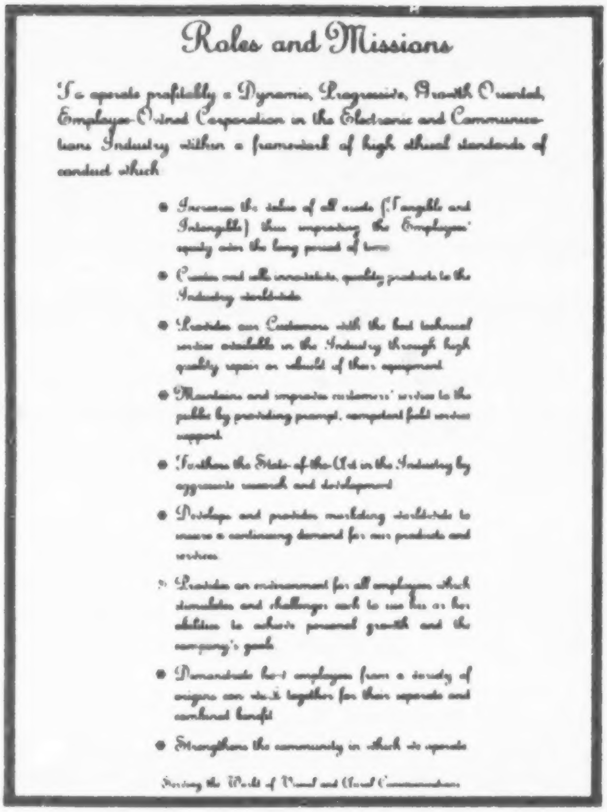
Warren Braun, President and Founder of ComSonics, Inc.

PROGRESSIVE!

In 1972, when the ComSonics ESOP was formed, there were few ESOPs around after which to pattern the company. In fact, Louis Kelso's writings were brought to the attention of Mr. Braun through a relative who had seen an article about ESOPs in a Chicago paper. When the first anniversary of the ESOP had been reached, Mr. Braun experienced "the worst day in the history of ComSonics. It was as if the employees had been handed a stone rather than the tools to work for greater profits. Not just for one year of profit but for years of profitabilty." At that point, changes were made. An aggressive and unique communications program was put into effect. An inhouse consultant was hired to inform all new employees how the ESOP works for their and the company's benefit. The concept of entrepreneurial risk is explained. "Employees must learn the concept of entrepreneurial risk in order to be top notch employees," stated Braun. "Growth occurs by meeting challenges and while you can make a point for security, a fear of failure is healthy. You have to learn to bob and weave with the punches. Risk is part of ownership." A full day is spent on understanding the ESOP. Once vested, the employee's ESOP account is fully explained by the employee's department manager—not someone from personnel or accounting.

ESOPs were new to the banking community in the early 70's thus time was spent with the bankers educating them to the needs and unique characteristics of ESOPs. Prior to 1983, the bank blocked the trustee from sitting on the Board of Directors at ComSonics because they felt it was a conflict of interest. The Board is made up of outside business experts and Braun is the only stockholder to sit on the Board.

Employees in addition to their ESOP account, also have major medical and hospitalization in-



Roles and Missions

To operate profitably a Dynamic, Progressive, Growth Oriented, Employee-Owned Corporation in the Electronic and Communications Industry within a framework of high ethical standards of conduct which

- Increase the value of all assets (Tangible and Intangible) thus improving the Employees' equity over the long period of time
- Create and sell innovative, quality products to the Industry worldwide
- Provide our Customers with the best technical service available in the Industry through high quality repair or rebuild of their equipment
- Maintain and improve customers' service to the public by providing prompt, competent field service support
- Further the State-of-the-Art in the Industry by aggressive research and development
- Develop and provide marketing worldwide to ensure a continuing demand for our products and services
- Provide an environment for all employees which stimulates and challenges each to use his or her abilities to achieve personal growth and the company's goals
- Demonstrate how employees from a variety of origins can work together for their separate and combined benefit
- Strengthen the community in which we operate

Serving the World of Visual and Aural Communications

surance, life insurance, tuition reimbursement for college courses, quarterly profit-sharing, and employee-of-the-quarter and year awards. If the company's profits exceed the budgeted predictions for the year, 50 percent of the earnings go directly back to the employees. The employee-of-the-year, voted on by all employees, is given a trip, not to an exotic vacation spot, but to a convention—to learn more about the business and technology for the company.

An underlying resource for the progressive participatory management at ComSonics is a book called ***The Mind of the Strategist*** by Kenichi Ohmae. One of the book's basic tenets is that teamwork is the key to solving problems but that does not mean everyone on the team is a follower; quite the contrary—everyone is a leader. Responsibility is implied at every level of the individual's/team's function.

Executives, as well as management and personnel experts, have come to Harrisonburg, Virginia to take a look at the progressive participatory management style at ComSonics. Sometimes the "experts" lose interest when they feel their traditional authority role threatened. Participatory ownership and management at ComSonics redefines the tasks traditionally associated with authority/management but the responsibility, according to Braun is probably greater. One of the tasks of management is peer critique. By looking at the twenty-three items reviewed in depth for each executive/manager an understanding of the change in emphasis from traditional authority role can be better understood. Leadership, openness, stamina and integrity head the list. Honesty, self-organization, empathy, diligence, objectivity and commitment are the next items. The list is rounded out by such items as discipline, courage, persistence, knowledge, self understanding, consistency, morals, communication, spirit, maturity, judgement and health habits.

Because of the value placed on permanent employees, in order to participate in the ESOP employees must be twenty-one years old and have worked for the company for one year. Vesting is 25% after five years, 100% after 15 years. The company currently has 101 employees; sixty-one employees are vested and they currently own 40% of the company. Repurchase liability will not be substantial for approximately 35 years because of the age of the employees and the 15 year/100% vesting plan.

When asked what problems faced ESOPs, Braun was quick to reply, "administration!" "Lawyers," according to Braun, "need to take on the job of simplifying the administration of ESOPs." Another area needing work is the valuation process for closely-held companies. ComSonics is a growth company and therefore is paying no dividends. According to Braun, outside appraisers tend to under value closely-held companies thus decreasing their borrowing potential. The valuation process at ComSonics is very formal. The stock was valued at $.92 per share in 1974. Last year the value was $3.37 per share and it is estimated to go to $4.01 in 1984. Employees who leave the company can retain ownership of their stock but the company has the right of first refusal for two years if they decide to sell the stock.

While the worst day was shortly after the beginning, the three proudest days in the company's history occurred in recent years. In 1982, ComSonics was listed by *Inc.* magazine as one of the fastest growing companies in the U.S.—30% per year for five years. Second, in 1983 ComSonics opened its new building and it was dedicated by Senator Paul Trible of Virginia with all the employees, their families and industry leaders present. Also in 1983, Senator Russell Long of Louisiana, a long time sponsor of ESOP legislation in the Congress, requested a profile of ComSonics be entered into the ***Congressional Record*** citing, "When more traditionally owned competitors are struggling to stay afloat, this ESOP company continued to surge ahead." And surge ahead is exactly what this ESOP company plans to do.

THE BASICS

NAME:	**ComSonics Employee Stock Ownership Plan and Trust**
YEAR ESTABLISHED:	**1974**
TYPE OF PLAN:	**Non-leveraged ESOP**
PERCENT OF COMPANY OWNED:	**40%**
PARTICIPANTS:	**60**
PLAN INVESTMENT:	**80-90% in ComSonics, Inc.**
VESTING SCHEDULE:	**Five years/25%; Fifteen years/100%**

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PROCEEDINGS AND DEBATES OF THE 98th CONGRESS, FIRST SESSION

Vol. 129 WASHINGTON, THURSDAY, APRIL 21, 1983 No. 52

Senate

ANOTHER SUCCESSFUL ESOP COMPANY

Mr. LONG. Mr. President, it was recently my great pleasure to visit with Mr. Warren Braun, president of ComSonics, Inc., a very successful company located in Harrisonburg, Va. In these severe economic times, it is encouraging to know that there are companies such as ComSonics, Inc., which are not only weathering the storm but actually prospering.

ComSonics was recently recognized by INC. magazine as one of the leading privately held companies in the United States with a 269-percent growth rate over the past 5 years. Mr. Braum attributes much of that success to the fact that ComSonics has an employee stock ownership plan (ESOP).

While more traditionally owned competitors are struggling to stay afloat, this ESOP company continues to surge ahead. Like many good managers, Mr. Braun recognized a number of years ago that his employees are his company's most important asset. Thus, in 1975, he established a plan to insure that his company become their company as well.

That farsighted approach has worked to the benefit of everyone. The employees now share in the success that they helped to create; Mr. Braun's own stock has grown in value; and the Federal Government is ahead as well, as ComSonics' growth has meant not only more jobs but more tax revenue as well.

Mr. President, it is gratifying to find that the ESOP legislation that I have sponsored over the past several years is being utilized and is enjoying such great success. I am convinced that widespread employee stock ownership can make a substantial contribution to reviving America's productive might.

Mr. President, I ask unanimous consent that a company profile of ComSonics, Inc. be inserted in the RECORD at this point.

There being no objection, the profile was ordered to be printed in the RECORD, as follows:

COMPANY PROFILE

ComSonics, Inc. is winning the battle against recession, depressed earnings and the general economic downturn suffered by most businesses, even with continued high investment in research and development. The Corporation's impressive growth record was recently recognized by INC. Magazine citing it as one of the top U.S. privately held corporations with a 269 percent growth over the past five years. Even at present, the Corporation continues to grow at a substantial rate mirroring the substantive base to its growth history.

Commenting on the INC. Magazine's recognition as the 457th growth corporation out of over 11,000 U.S. privately held corporations, President Braun said, "It's our employees—and ESOP." "Great people with a meaningful incentive make for a great company."

This all started in 1970 when Warren Braun, a consulting engineer in the cable television industry, saw the need for an independent research and development firm that would provide a wide variety of technical services for CATV systems. The idea took shape as ComSonics in 1972, as Braun, a group of young engineers, and Braun's wife, Dickie, working out of the Braun's basement as a consulting firm launched the new venture. Now eleven years later, with approximately 89 employees, the Brauns are seeing another idea come to fruition, namely the transformation of ComSonics into an employee-owned corporation.

Braun, who serves as president and general manager, believes it's the only fair thing to do. "What better way can appreciation be expressed to those who helped found a company and contributed to its success than to make those employee company owners?" he asked. In 1975, Braun established a trust with 25,000 shares of newly issued common stock which were bought with funding provided by the corporation. The next year an additional 72,000 shares were bought from funds borrowed by a local bank. The 96,000 shares are allocated to ComSonics' employees, making the firm wholly employee-owned.

The purpose of the ComSonics employee stock ownership plan (ESOP) is to assist the employee to accumulate stock ownership in the firm, thus providing the employee and the employee's family with further economic security. Stated Braun, "It has always been my firm belief that employees contribute to the growth of a company as much as capital, and employees should therefore participate in that growth. The major problem with that idea was how could employees participate without confronting an immediate tax liability. The solution was the ESOP. All employees will only pay taxes on accumulated capital when it is withdrawn from the trust as a stock certificate, when the employee retires, dies, or leave the company.

The key to the transfer of ownership depends upon the growth of the company. At the end of each fiscal year (July 31) ComSonics' Board decides how much additional money can be put into trust for stock purchase in the ESOP with the ultimate objective to purchase all of the remaining stock of the corporation currently owned by the principal employee stockholder, Braun, for the remainder of the employees. Eligible employees are those who are 24 years of age and have completed at least 1,000 hours of service during the first 12 months of employment. The yearly portion is determined by how much ComSonics contributes to the trust. ComSonics's contribution to the trust is derived by the corporation's earnings. In turn, the ComSonics' contribution to the trust is divided by the new per-share-stock value. These shares are then set aside for the eligible ComSonics employees. An employee's portion is based upon the percent of compensation in relation to the total eligible payroll.

Knowing what's at stake, ComSonics' employees are more conscientious of their work. "They act more like stockholders than employees," said Braun, "which is what they are." The Brauns are extremely proud of their employees. "We've collectively had our shoulders to the wheel from the time we started this company to make it what it is today."

Today, most of those "boys from the basement" are still with ComSonics. They head the four profit centers of the company: Dennis Zimmerman, Vice President, Systems Services; Carl Hensley, Vice President, Internal Operations; Richard Shimp, Vice President, Research and Corporate Development; and Glen Shomo, Vice President, Product Production and Development. Mrs. Braun serves as corporate secretary/treasurer and remains active in the firm's day to day activity. The ESOP idea was prompted in part by their loyalty and dedication to ComSonics. "People who work so long and hard as these men did to help start this company deserve something of importance in return," stated Braun. "Other stock bonus plans tend to have near term tax consequences, and are usually heavily weighed for upper income personnel. ESPOs benefit every worker."

During this short life, ComSonics has generated an impressive list of new and unique ideas represented by several U.S. and foreign patents.

Hensley, Zimmerman, and Shimp rank highest on the seniority list, but they have also set a trend. The employee turnover at ComSonics for full-time workers is only around three percent per year.

ComSonics is managed by advance management-by-objective (MBO) techniques. It is run by the department heads who are guided by objectives they set each year. The company has a management consultant John Dickie who also provides extensive in-house training programs. Any employee who wants further training and education in his job area can pursue it at the company's expense. For grades of an A or B, the company will pay 100 percent of the expenses.

One aspect of the management system is the annual company performance objective. This involves another form of profit-sharing, apart from the ESOP. Braun explained that each year a dollar amount is projected for the company's performance. If the performance objective is met, 50 percent of the profit earned over the objective is distributed directly to all employees in cash. The other 50 percent goes into advancing the corporate expansion. This year the fiscal corporate growth is 33 percent to date, exemplifying continued compound growth.

The newest and most recent company incentive is the Employee of the Year award. This award was devised and proposed by the second-level management personnel without any input from the department heads. The supervisors established the award for the employees under their supervision which activity is restricted to employees outside of the management team. The employee who earns this award receives an all expense paid trip for two to the National Cable Television Association's annual conventions.

Incentives change each year at ComSonics, as they do at other corporations, to keep employees interested and motivated. But, as one ComSonics' employee put it, as far as he was concerned, "the biggest incentive of all is simply the fact that I'm an owner."

Comsonics Employes Putting Money Where Their Jobs Are

COMSONICS, From page 1

Braun the employe became Braun the boss in 1965 when he and his wife launched an engineering consulting firm from the basement of their family home. "We started out with the idea we'd have something for our retirement," Braun explains.

That modest enterprise evolved into Comsonics, a company that makes accessories for the cable television and telecommunications industry. Comsonics had sales more than $4 million last year and a hard-charging growth rate over the past five years of 269 percent. It was named one of the nation's top 500 fastest-growing privately held companies in 1982 by Inc. Magazine.

It also has grown into a pioneering management effort in which employes are decision-makers and own roughly 40 percent of the company stock under an Employe Stock Ownership Plan (ESOP).

"I've always had the idea that participatory management and participatory ownership was something that would work, that the two should go hand-in-glove," Braun said.

> **"I sincerely believe that part of what people earn [by doing their jobs] is the right to participate in the ownership of the company. If you can't live what you say, then it's a pretty hollow message."**
>
> —Comsonics President Warren Braun

Braun was given the opportunity to test this hypothesis in 1974, when Congress passed the Employee Retirement Income Security Act. That legislation eased the way for ESOPs, and Braun wasted no time in establishing such a plan for his company that very year.

Under Comsonics' ESOP, Braun plans eventually to relinquish all of the stock he owns in the company he founded and whose business is booming. "I could have maximized the return to myself, but that's only financial return," Braun said. "Fulfillment comes from working on things and seeing them accomplished and seeing others' lives enhanced because of it."

ESOPs are among the fastest-growing employe benefits in the country, according to the Employee Benefit Research Institute. Currently, more than 4,000 such plans are in operation, providing a new form of compensation for more than 6 million employes. The institute says, however, that ESOPs account for less than 1 percent of all defined contribution plans, partly because they were so recently created.

ESOPs differ from other profit-sharing programs in that employes acquire an ownership interest in their company. The Comsonics version of the plan is distinguished by the fact that it invests primarily in stock owned by the employer rather than in stock issued by the company expressly for employes to buy.

Comsonics' business is designing accessory devices for cable television systems and repairing cable television equipment. It also acts as a consultant in all phases of cable television installment, from mapping to field support.

Additionally, Comsonics devotes considerable effort to research and development, which has resulted in devices such as the soon-to-be-marketed "sniffer system." The device emits a bleep when a cable television station is malfunctioning and can save repairmen the time and trouble of climbing every potentially malfunctioning pole when trying to locate a station with a problem.

The 61-year-old Braun is a large man with a crewcut who mixes a Midwestern accent with the demeanor of a southern gentleman. An award-winning engineer, he keeps a copy of a book entitled "The Mind of the Strategist, the Art of Japanese Business" on his desk for easy reference. He reads passages from the book aloud to a visitor.

"I sincerely believe that part of what people earn [by doing their jobs] is the right to participate in the ownership of the company," he said.

"If you can't live what you say, then it's a pretty hollow message."

To establish the ESOP, Comsonics' board of directors took a portion of the company's earnings and bought a block of stock, about 29 percent, from the company treasury, Braun said.

Later, the board borrowed a lump sum of money and bought the additional treasury stock. With the board's third purchase of stock, it began to buy out Braun's stock. At the end of the company's fiscal 1982-83 year, which ended July 31, the employes owned about 130,400 shares of Comsonics stock.

Braun, the only director on the board to own stock, controls the remaining 60 percent (204,100 shares). He predicts the employes will own all of the stock within six or seven years.

The Comsonics board of directors sets aside a certain portion of each year's earnings to purchase stock for the employes. Stock ownership is directly proportional to each worker's salary, exclusive of commissions and overtime. Currently, about 60 workers out of the company's 94 own stock.

To keep the ESOP in the hands of permanent employes, ESOP members must be at least 24 years old and have worked at Comsonics for at least a year. Employes who leave Comsonics can retain ownership of their stock, but the company has the right of first refusal for two years if they decide to sell the stock.

In 1974, Comsonics stock was valued at 92 cents per share by an outside appraiser. Last year, it was valued at $3.37 per share. The company estimates this year's value will be $4.01 per share.

The company also provides other employe benefits, including term life insurance, full hospitalization and tuition reimbursement programs. If the company's profits exceed the budgeted predictions for the year, 50 percent of the earnings above the forecast goes into employe profit-sharing.

Photo by James M. Thresher—The Washington Post

Comsonics President Warren Braun and employes outside the Harrisonburg facility.

"I can say . . . the corporate growth is bigger, is healthier, provides a way in which people can participate and provides levels of productivity that you don't get" in traditionally managed and operated companies, especially those firms in the high technology field, Braun said.

In addition to owning stock, Comsonics employes participate in goal-setting and decision-making.

The key to a successful company, Braun says, is to "let the employes, those closest to the scene, originate objectives . . . and upper management coalesces these objectives so it is profitable for all."

After establishing the ESOP, all Comsonics employes, exclusive of Braun, gathered to thrash out company objectives. These objectives—entitled the "roles and missions"—are posted throughout the one-story, U-shaped building that houses the company.

Implementing his management and ownership theories took hours of time and effort on everyone's part, Braun said, admitting that the first year he feared it had "landed on the floor . . . with a dead thud."

"I knew if you wanted participatory management, you had to retrain the employes, because, unfortunately, our school system doesn't teach people to be entrepreneurs," he said. He sought to bridge this gap by hiring a management consultant to work with employes.

They had to learn to understand the constraints surrounding decisions, he said. For instance, every employe, beginning at the supervisor level, learns to read a financial statement and to analyze it. Division managers try to align finances with their functions, Braun said.

Each year, Comsonics employes establish a new plan of operation and routinely monitor the plan throughout the year. The exchange of ideas and information among employes at the same level on the corporate ladder as well as up and down that ladder is frequent and encouraged.

The top-level executives—managers and vice presidents—meet in monthly sessions to evaluate company performance and analyze financial results. Braun does not participate in these "peer" meetings.

Supervisors meet in a similar monthly session, then the two groups hold a joint meeting. Employes consult with their supervisors as often as three or four times a day in informal fact-finding, problem-solving sessions, Braun said.

"As a consequence of this, my role in managing this company is very different than the normal directory-type management [in most companies]," Braun said. "I am guiding, not directing."

Not only is the company profitable, but employes say they are happy with their jobs. Sandra Munsn, assistant to Braun and

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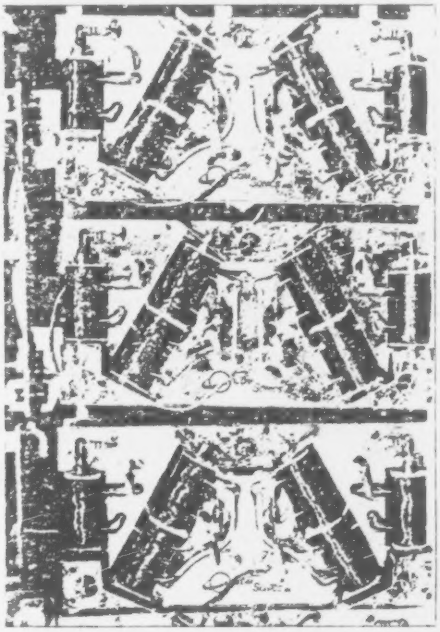


Photos by James M. Thresher – The Washington Post

Elements of an intelligent coaxial relay, top left and above, are two of the technical products manufactured by Comsonics for the cable TV industry. Technician Mark Miller, at bottom, adjusts a cable system's rebuilt TV modulator for the branch of the company involved in repair and rebuilding services. Comsonic's telecommunications manufacturing ventures and its service division, combined with its research and development, have enabled it to achieve a growth rate over the past five years of 269 percent. Below, company President Warren Braun.

From preceding page

supervisor of secretarial support services said, "I certainly feel my self-worth has increased."

Munns contrasted this with her other work experience, in which she said she was "treated as a second class employe. You're there to do a job and you keep your opinions to yourself."

> **"People take their jobs, I think, very seriously," Braun said, citing Comsonics' 3 percent annual employe turnover rate. "When the company fails, they feel a personal failure."**

Braun cites the 3 percent annual employe turnover rate as one sign of employe satisfaction.

"People take their jobs, I think, very seriously. When the company fails, they feel a personal failure," he said.

Braun says many executives have expressed interest in the participatory management and ownership at Comsonics, but they back off, he says, when they realize it means resigning some of their perceived authority.

Participatory management and ownership does not mean executives shed their responsibilities, Braun says.

"You actually have a greater responsibility. You must work around the greater freedom given to employes to show them something they're doing isn't working to the best benfit of their goals."

Despite these reactions, Braun predicts that the concepts in management and ownership in which he has so much faith will become prevalent in business within the next generation.

"Everybody is going to be a leader," he says. Teamwork is the key, with a "team captain to coordinate and maximize the efficiency of interrelationships and increase the performance of every individual."

He says the Japanese already teach these ideas in their educational system, which gives them their edge over American business.

Citing Kenichi Ohmae's "The Mind of the Strategist," he says the Japanese emphasize group harmony while discouraging individual heroics. They teach their children, first of all, that they must work or starve, Braun says. Secondly, the children are taught that the more intelligent among them must use their talents to ease the way for the slower ones.

"I believe until we learn this lesson, we are not going to be able to compete successfully" against the Japanese, Braun said.

Daily News-Record
Harrisonburg, Va., Tuesday, April 16, 1985

Incentive

ComSonics Wins Productivity Award

ComSonics, a Harrisonburg firm that produces cable television and satellite communications equipment, was cited Monday as the Virginia manufacturing company with the best program for encouraging workers to produce.

The company received the U.S. Senate Productivity Award given each year by Virginia Sens. Paul Trible and John Warner.

The award is based on a company's program to inspire employees to perform well and be productive, said the two senators.

ComSonics President Warren Braun received the award during a luncheon Monday in Richmond.

A year ago, ComSonics was runner-up to Phillip Morris for the manufacturing award.

This year's non-manufacturing award went to Babcock & Wilcox Nuclear Power Division in Lynchburg.

ComSonics was cited for its employee ownership and management program.

Employees now own 48 percent of the stock in the company, Braun said Monday. He also noted that practically all company decisions are made by ComSonics' employees.

Every manager and supervisor of the same level meets with fellow workers from other departments once a month to discuss problems, Braun explained. There also are regular meetings where "all the titles are thrown out" and managers and supervisors meet together, he added.

"We get more ideas than we can say grace over," he said of the role employees play in the company. The exchanges also have produced 16 patents for the company.

ComSonics is the outgrowth of a consulting engineering operation Braun started in the basement of his Harrisonburg home in 1965.

By 1972, the manufacturing portion of the business had grown to 23 employees.

When the federal government that year approved a new Employee Stock Option Program, Braun and his wife, Diki, decided to incorporate ComSonics and turn part of the stock over to employees.

A major reason for the move was the "team" which had been developed by that time, Braun explained.

It included Carl Hensley, Dick Shimp, Glenn Shomo and Dennis Zimmerman, Braun added. Hensley died a year ago, but Shimp, Shomo and Zimmerman, along with the Brauns, remain the ComSonics management team.

Under them are 15 supervisors.

In 1974, ComSonics moved out of the Braun's basement to a new building on Port Republic Road. At that time, the company had 23 employees. Today, it has 120, Braun said.

The number of employees is not the only thing which has grown. For the five-year period which ended in 1982, ComSonics was rated by Inc. magazine as one of the 500 fastest-growing companies in the United States.

ComSonics grew 200 percent during the five years, Braun added. Growth since has been at 18 to 30 percent a year, he added.

He credits the success to contributions by employees.

Apparently, employees' attitudes were what impressed the five-member committee which visited the plant early this year and decided that ComSonics should receive the U.S. Senate Productivity Award.

The stock ownership and regular meetings to exchange ideas and solve problems are not the only unusual approaches at ComSonics.

There is a "peer review" system, in which workers rate their fellow workers.

There also is a "flex time" system, under which employees can set their own hours. The only restriction is there must be a supervisor on duty during production time, Braun explained.

Last year, the company also put on a workshop to explain the stock ownership system to workers. Employees do not have to buy the stock, but can earn it "through the sweat of their brow," Braun said.

There also is an advancement training program for employees who want to move up.

Is there anything new left for ComSonics?

Lots, says Braun.

A Texas plant is planned later this year, and a new product will be announced in May, he said.

The Texas plant will be built to reduce the shipping of West Coast satellite units for repair, Braun explained. The plant probably will be in the San Antonio or Austin areas, but an exact location has not been picked, he added.

The new system which will be announced May 24 is called "Window," but Braun said he could say no more about it now.

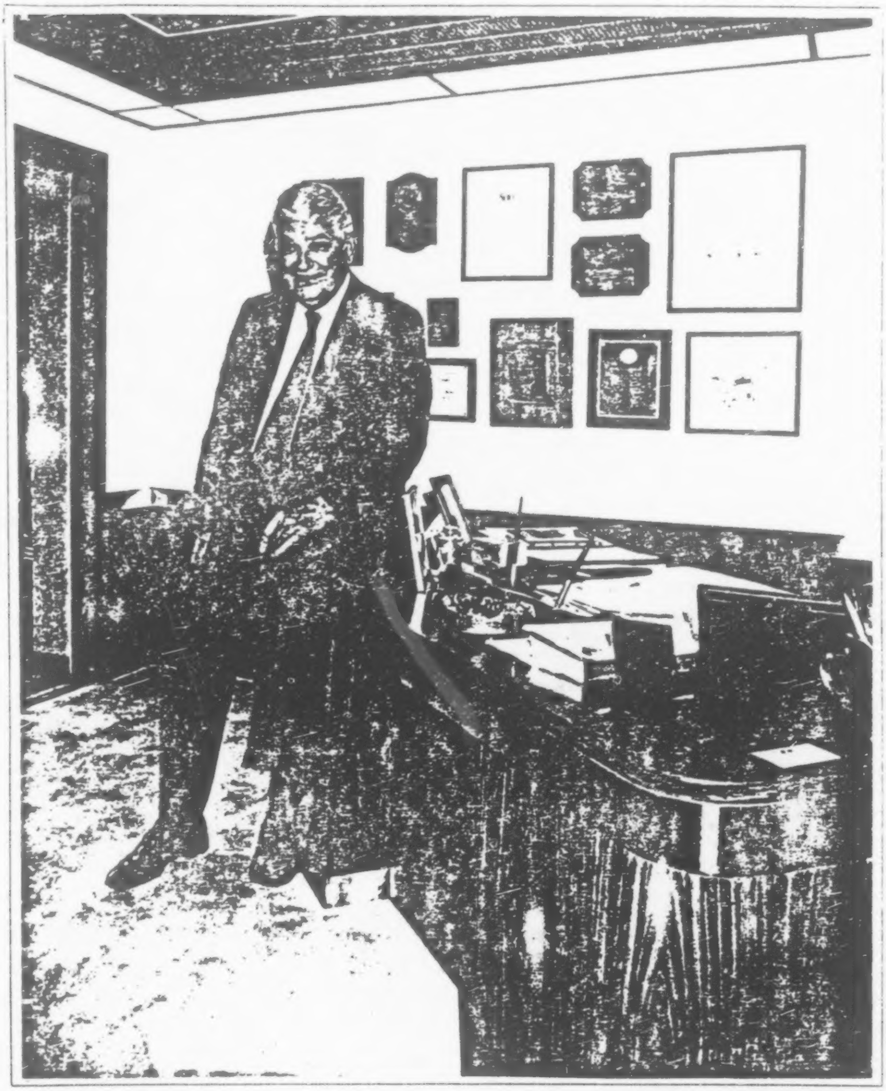
Although much of ComSonics' work has involved cable television, the company also has been involved with satellite communications, acoustics and recording systems.

A "sniffer system" the company produces detects leaks in cable systems by picking up a special radio wave. The sniffer can work from a fast-moving car, which permits quick and easy monitoring of a system, Braun said.

Another device ComSonics has developed will detect an attempt to "break into" a computer system and shut down the system before the culprit can obtain information, Braun said.

However, the most pressing project currently is celebrating the company's selection for the Senate Productivity Award, Braun said. Employees already have indicated they have plans along those lines, he added.

Braun holds ComSonics' medal.



Braun's confidence in his employees is the basis for the participative management and ownership at ComSonics.

HOW TO WIN FRIENDS AND INFLUENCE PROFITS

Warren Braun, founder of ComSonics, shares ownership, management and ample profits through his employee-oriented philosophy.

Article by Leslie Smith *Photography by Steve Emerson*

A ship's bell sounds, and Warren Braun, president of ComSonics, Inc., jumps enthusiastically from his seat. The bell continues ringing as he hurries out of the office into the hall, where excited voices and congratulations are heard. Braun explains that an employee sounds the bell when a sale is closed for a piece of equipment. This time, though, the bell rings much longer than usual, indicating that all of the month's production has been sold out in advance.

"I had promised that if they sold it by the 15th of the month they would each get a bottle of champagne. But since they did it with such a bang — went clear over the top — they'll get two bottles of champagne each," Braun says proudly. The "they" is what Braun considers the most important ingredient in the company's success — its employees.

Braun is proud of the fact that 82 of the 118 employees own stock in the company.

It is to those employees that Braun attributes ComSonics' impressive growth record. In 1982, *Inc.* magazine recognized the Harrisonburg company as one of the country's 500 fastest-growing, privately owned companies. With a 310 percent growth rate over the five years from 1978-1982, ComSonics had sales exceeding $4.5 million in 1983. Braun thinks this year's sales will exceed a 30 percent annual growth.

"At the rate they're going, I believe they'll do it," Braun says.

The company is an outgrowth of a part-time engineering consulting practice which began in the late 1960s in the basement of Braun's Harrisonburg home. ComSonics was officially formed Aug. 1, 1972, and has been in the business of rehabilitating and reselling cable, satellite and other electronic equipment since then. It also designs and develops cable systems and continues to act as a consultant for companies desiring to enter the cable TV business. Because the industry is fairly new, ComSonics devotes considerable effort to inventing, researching and developing new products.

Braun's loyalty to his employees is the basis for the structure he has developed at ComSonics. The management is participative; the employees are active in objective-setting and decision-making. His conviction that people are "by-and-large heroic, considerate and selfless" is shown daily through the trust Braun places in their judgment to make decisions concerning company objectives.

Braun disagrees with B.F. Skinner, the behavioral psychologist and author of *Beyond Freedom and Dignity*, who believed that people are best motivated by appeals to physical gratification. Braun believes people rise to goals higher than physiological needs.

"There is something about the sense of accomplishment when an individual has set a goal and achieves it himself," Braun explains. "There's an intrinsic factor that elevates that person's self-worth. They suddenly feel rewarded like nothing else can reward them." Braun feels so strongly about the theory of self-worth, where the dignity of the individual is important, that it was necessary to make this idea possible in his business.

Two things are needed to facilitate his theory, according to Braun. First, people must participate in the management so they not only have the feeling but also the reality of making their own success. To complement the participation, Braun believes the individual should benefit financially and not just with money earned by salary. "What they really need is a piece of the action," Braun says, "and somehow that's got to be each and every person in the firm."

The employees have put these ideas into the "Roles and Missions" statement which hangs in every ComSonics work place. The statement expresses what the employees believe their company should be, and provides a format for their thinking. According to the statement, ComSonics is committed "to operate profitably in a dynamic, progressive, growth-oriented, employee-owned corporation . . . within a framework of high ethical standards of conduct . . ."

The key idea in the "Roles and Missions" statement is that ComSonics is an "employee-owned corporation." In 1974, the company was one of the first to introduce an Employee Stock Ownership Plan (ESOP). The purpose of ComSonics' ESOP is to help the employees accumulate ownership in the firm.

Since Braun knew the average person working for an hourly wage could not afford stock, ComSonics' board of directors allocates a percentage of each year's earnings to purchase stock for the employees. Ownership is directly proportional to each worker's salary level.

In order to participate in the benefits of the ESOP, employees must be at least 21 years old and have worked for the company at least one year. Today, ComSonics has 118 employees; 82 are stock owners.

Currently, the employees own 48 percent of the stock, and Braun owns the remaining 52 percent. Under the ESOP, Braun plans to eventually relinquish all his stock. "My objective is to have 100 percent employee-owned stock within five years," Braun says. This should occur around the time Braun plans retirement.

Braun's theories contradict the ideas he recalls reading in Skinner's *Beyond Freedom and Dignity*. "I wanted to take that book and throw it right straight out the window. He said dignity and freedom are really unimportant terms. I said, 'You know Skinner, you're wrong. That is the grossest of all philosophies. It is where you pander to the lowest element of what a human being can be. But it doesn't need to be that way. That's not the way you get the highest productivity; that's not the way you get the greatest peace among people, and I'm going to prove it, sir.' "

The implementation of a participatory ownership system would provide this proof, Braun believed. But when he first became interested in the ESOP system, a roomful of accountants and lawyers advised Braun against it. "I said that anyone who couldn't stick behind the idea with strict faith and confidence could leave the room right then," Braun recalls. "Well, no one left that room. They see the value of it now."

Money and growth were problems in those first years of ComSonics. "We started on a shoestring and a prayer," Braun remembers. "The prayer was short and the shoestring broken in several places."

Braun and his wife, Dickie, who remains active in the company as corporate secretary/treasurer, wondered at first whether to keep the company going. "We decided we had a fine staff, and it would be a shame not to go through with it. The idea was to see them through the rough period," Braun says.

Braun's background in electronic engineering helped give him the confidence to take the risk. Braun came to Virginia in 1941 after graduating from Valparaiso Technical Institute in Indiana with a degree in electronic engineering. He met Dickie at his first job.

That year, Braun supervised the installation of a radio station and worked there as chief engineer. He designed and built six radio and television stations in the following 25 years. In 1957, he became general manager of WSVA with the provision he could remain active in his consulting practice (which eventually became ComSonics).

During its 13-year lifespan, ComSonics has operated under several dif-

Braun makes a daily tour of ComSonics' facilities to discuss business problems or just to chat with the employees.

ferent planning techniques. Last year, the company switched from five-year planning to a new form not yet in the textbooks. It is called the forecasting of goals and objectives by strategic planning units.

Each unit clearly describes the goal and market. Then the timetable, costs and manpower are specified.

Teamwork and participation are key elements in this system. Each year the employees set a dollar amount for the company's performance objective. If the profits exceed the prediction for the year, 50 percent of the earnings are dispersed to everyone in the company. Braun says, "Everyone gets a bonus check; every employee except me. I don't get any of that." This form of profit-sharing is another facet of ComSonics' management system.

In some instances, workers have designed their own incentive plans, Braun says. They don't want profits distributed by salary alone because not everyone works equally as hard. "In this company," Braun says, "supervisors don't measure relative productivity, employees measure it themselves. They set up the system, manage it and make it functional.

"When it shows up that a worker is dragging his tail, his fellow workers will have a talk with him about it," Braun says. "Isn't that wonderful? That's what you would hope would happen. The dignity of man is there when he finds the opportunity to participate in management and ownership. It does work."

Braun's confidence in this theory and its success at ComSonics played a part in his recent election as president of the ESOP Association of America. Through his new position, Braun hopes to assist others who are interested in the participatory concept of management.

Braun enjoys giving lectures on employee stock ownerhip or other topics. He estimates that 70 percent of his lectures are non-technical and include such topics as: the meaning of the 4th of July, the future role of agriculture, making a positive impact on the world, and the true meaning of personal committment.

The same enthusiasm that goes into ComSonics is also invested in Braun's hobbies and interests. Braun enjoys writing technical articles for professional uses as well as writing prose and poetry for his own enjoyment.

Landscaping and woodwork designing are other interests. A recent creation is a pair of wooden bookends with entwining hearts that Braun gave his wife for Valentine's Day.

He also loves music and collects a variety of recordings. "I like new wave music right now," says Braun, "Of course I still like the Old Masters provided they don't bore me too much. I get 'Bachitis' sometimes."

This dynamic personality is evident in Braun's leadership style. He considers his number one role a cheerleader. Of course the employees get commissions, but Braun believes what's more important is the surmounting of goals set themselves. "Sure they're going to get the champagne, but heck, two bottles of champagne don't cost all that much," Braun says, "It's simply the badge that says, 'Hey, you did it.' That's why they'll go home with the pride tonight." Although not a conventional management practice, Braun stresses employees achieve their individual potentials.

Apparently Braun's method has triumphed. In leading the company toward its greatest potential, ComSonics' dedicated employees are proving Braun's theories of success and self-worth. ☐

Leslie Smith, a senior from Springfield, Va., is a communication arts major and a business administration minor. She will be graduating with honors in May and is seeking a career in corporata public relations.

Roanoke Times & World-News, Sunday, June 23, 1985

BUSINESS

ComSonics employees share responsibility, ownership of company

By OZZIE OSBORNE
Staff writer

HARRISONBURG — At ComSonics, a rapidly expanding high-tech firm here in the Shenandoah Valley, employees share responsibilities and ownership with management.

And this unique system is what makes the company so successful, says Warren Braun, who founded the company and is its president.

Inc. magazine cited the company as one of the fastest growing in the United States when, in a recent five-year period, it grew by 269 percent.

ComSonics has also been recognized as the Virginia manufacturing company with the best program for encouraging workers to produce. For that, it received this spring the U.S. Senate Productivity Award given annually by Virginia Sens. Paul Trible and John Warner.

Braun attributes the success of his company, which produces cable television and satellite communications equipment, to two factors:

- An employee stock ownership plan, or ESOP, set up a decade ago under which employees have acquired about 45 percent of Braun's ComSonic stock. Eventually, they will own it all.
- A system of participatory management that encourages all employees to help solve company problems.

The company, which also designs cable systems and serves as a consultant to companies entering the cable TV field, projects annual sales this year of $5 million. Annual growth is expected to be about 30 percent, Braun said.

A staff of 20 researchers is an important part of the work force of 119.

The ebullient Braun refers to himself as merely his company's cheerleader — but he gives the impression he is decidedly more than that. He says quite candidly that he expects the very best from all of his employees.

"Why shouldn't I demand excellence?" he asks. "I expect employees to excel beyond what they ever thought they could."

Braun keeps a close eye on the performance of the company's top management, writing 17-page reviews annually on each of the firm's five vice presidents.

The five, who range in age from the late 20s to the early 40s, may be on edge now since the one Braun considers most capable is expected to succeed him when Braun leaves the company in four or five years. Well before that time, employees will be sole owners of the company.

An ESOP, which Business Week magazine has called "a remarkable force sweeping American business," works like this:

A company annually sets aside a certain amount of money to buy the company's stock from the owner or owners and distributes it to eligible employees. Eventually, the employees own the company. A trust usually handles the transaction.

Braun is one of the business community's most avid exponents of ESOPs.

He points to the obvious financial benefits ESOPs give employees, as well as the pride and incentive they instill.

While Braun emphasizes the benefits to employees, owners of businesses benefit from ESOPs as well.

Billy H. Branch, a Roanoke contractor, has established an ESOP at Branch & Associates where he owns more than three-fourths of the stock.

"It gives you a market for your stock. If you're a small, non-public company, it can be very difficult to find a market. It gives you liquidity.

"And as you grow older, you start thinking, well, you have a lot of equity in your company, but you might want money."

The amount companies put aside each year to fund ESOP programs varies. At ComSonics, as little as $10,000 and as much as $120,000 have been put in a trust at one time to buy the company's stock for distribution. Much depends on how much of the company profits are reinvested in the business for research, equipment and other purposes.

The higher the salary of an employee, the more stock he or she gets.

Taxes are paid on stock when it is withdrawn at the time an employee dies, retires or leaves the company. An employee who leaves ComSonics can keep his stock, but the company has the right of first refusal for two years if the employee decides to sell his stock.

An independent appraiser determines the value of the company stock annually. Its original value was 85 cents a share; recently, it has varied from $3.37 to $3.70.

Braun recalls that when he told his lawyers and accountants he planned to set up an ESOP, they advised him against it.

"They said you will never get for your stock what you would on the open market," Braun recalls.

He and his wife, Dickie, a mainstay of the company and its secretary-treasurer, ignored the advice. He obviously thinks the decision was right: The company's growth has exceeded expectations, employees feel secure; they are motivated to do a better job; and they are more apt to stay with the company, he says.

Judy Bent of Career Development Consultants, an employment agency in Harrisonburg, says she tries when possible to place people at ComSonics, "since I know people will be treated with respect, with dignity . . ."

"At ComSonics," she says, "there is much talent as well as much caring. A lot of people want to work there. It is a tremendous asset to this community."

Don Suter, ComSonics controller, summed up his feelings succinctly: "Here you are given freedom to perform."

Sandra Munns, who is supervisor of secretarial support, said, "I feel this is part of my company." That comes in part, she said, from the ESOP program.

"It really gives incentive to hang in there," says Munns, who has been with the company a decade now.

Pete Phillips, a 25-year-old draftsman, thinks the ESOP is particularly valuable for one his age — "especially when you think of what it will amount to when you retire."

"And the feeling here is like it is in a family," he says. "I don't know how it has remained that way, but it has."

There are other less definable reasons why Braun wanted to start an ESOP. He had always thought he wanted to own something. But when he became part owner of a Charlottesville radio station, he thought employees as well as owners should share in the profits. That led to setting up the ESOP, which, he says, has led to the satisfaction he sought in business.

Berry Grant Jr. (left), Glenda Hill and Greg Spitler discuss production schedule in the head-end repair department

Braun thought sharing profits would make workers better employees, but the ESOP in itself was not enough. Employees also ought to have a say in management.

Braun always thought a secretary should be made to feel as important as a company president. That's where participatory management comes in.

The vice presidents meet twice a month to talk about problems before they begin to fester. "I don't attend," says Braun, "because my influence could go one way or another."

Braun does, however, insist on being consulted when changes are made in policies or budgets that employees themselves have laid down.

An outsider works as a facilitator with the vice presidents to avoid any blood-letting and see disagreements are handled fairly.

Periodically, the vice presidents and more than a dozen supervisors meet to solve company problems.

Other employees discuss problems at coffee breaks and meetings where they make recommendations — recommendations that are acted on. If employees don't feel they have the right equipment, they let it be known.

"They measure their own productivity," says Braun. "They know what they need."

Braun says some people think employees shouldn't have as much power as they're given at ComSonics.

"Baloney!" is his reaction.

"Of course, they've got to function responsibly. You have to have checks and balances."That aside, Braun feels that people must — if they are to realize their full potential — have a say in running their workplace.

The stock a person gets through an ESOP is fine, he says.

"But if you don't feel that you can do something about what's happening at the company where you work — well, it's just a job."

Braun also believes employees should know about their company's finances — so he shares all of the information about how much the company makes and where its money is spent.

"By knowing all about this, they know how important saving money is," he says.

Employees also hear lectures on how a company works under the free enterprise system. "People don't understand investment, return on investment, what stock is.

"Some think profits run to 25 or even 50 percent. They are astounded when they find out what it really is."

At ComSonics, the profit margin is about 4 percent because, says Braun, "we reinvest so much in equipment and research."

The way Braun runs his company fits in perfectly with his personal philosophy. "I happen to believe that all people who have any opportunity to contribute in any way to society have a special responsibility to assist others in growing to be better people.

"I think this is what Jesus meant when he said it's one-on-one that you've got to be judged. How did you treat your fellow man? Did you treat him with dignity? Did you make him better than he was yesterday?"

Braun got his start in building and rebuilding radio and television stations in Harrisonburg, Staunton, Baltimore, Winter Haven, Fla., and other places.

Later, when he was running a consulting business from the basement of his home, Braun, his wife and some of the men who are still with him established ComSonics.

The date was Aug. 1, 1972; three years later Braun set up his ESOP with 25,000 shares of newly

BETTY MASTERS/RT&WN

ComSonics vice presidents (from left) Tom Robinson, Glen Shomo, Dennis Zimmerman, Dick Shimp and Mark Barber during one of their regular problem-solving sessions

issued common stock bought with money provided by the corporation. Braun was on the way to realizing a dream of sharing his profits with those who made them possible.

Braun is almost evangelical when he talks about the value of letting people own and run a business — "two-factor capitalism," he calls it, saying:

"These (shared management and ownership) are two things looking for each other in our society and when you put them together they make a doggone good marriage.

"What a tremendous difference in motivation it brings out. And it brings out pride and real dignity.

"There's dignity in the workplace."

Sen. Russell Long (D-La.), who has sponsored ESOP legislation over the years, attributed to Braun in a Senate speech a "farsighted approach that has worked to the benefit of everyone.

"The employees now share in the success that they helped to create; Mr. Braun's own stock has grown in value; and the federal government is ahead as well since ComSonics' growth has meant not only more jobs, but more tax revenue as well."

1. INTRODUCTION

ESOPs Face A Challenge

From 1973 to 1985, Congress has endorsed and encouraged Employee Stock Ownership Plans (ESOPs) in numerous laws. For example, the 1984 Tax Reform Act contained important incentives for employee ownership, and both the House and Senate versions of the 1985 Foreign Aid Act provide for the encouragement of ESOPs in Central and South America.

Now, the Administration tax proposal, while using pro-ESOP rhetoric, actually recommends major, and mainly detrimental changes in ESOPs. This notebook answers the challenge.

2. BACKGROUND

What Are ESOPs?

An ESOP is a tax-qualified plan under which employer stock is held in trust for the benefit of employees. Thus, an ESOP provides an employee benefit that enables employees to gain an ownership interest in their employer.

The stock may be acquired through direct employer contributions or with the proceeds of a loan to the trust. Contributions to an ESOP whether in the form of stock or cash are deductible by the employer, as are contributions made to any other tax-qualified plan. If stock is contributed, its value is the deduction. This is a nonleveraged ESOP. If an ESOP borrows money to purchase stock, employer cash contributions may be used to repay the loan and such contributions are deductible. This type of ESOP is referred to as a leveraged ESOP. Because an employer's ESOP contributions are fully deductible, in a leveraged ESOP both principal and interest payments are deducted.

After being acquired by an ESOP trust, the stock is held in an escrow account for allocation to individual employee ESOP accounts. ESOP participants "earn" their ownership interest through continued employment with the company and incur no out-of-pocket cost for allocated stock.

3. PURPOSES OF ESOPs

The purposes of ESOPs are essentially two. They are:

- To accumulate the ownership of capital by employees in order to lessen the concentration of wealth without using a redistribution of wealth scheme; and

- To aid in corporate finance.

From these two purposes of ESOPs flow many other ancillary benefits which are frequently present in an ESOP company. These are:

- Increased productivity;
- Improved employee-management relations;
- Large accumulation of wealth by employees;
- Increased cash flow for corporations;
- Easier access to capital markets for corporations.

The purposes of ESOPs were set forth clearly in subsection 803(h) of the 1976 Tax Reform Act, which provides:

> "The Congress, in a series of laws . . . had made clear its interest in encouraging employee stock ownership plans as a bold and innovative method of strengthening the free enterprise system which will solve the dual problems of securing capital funds for necessary growth and of bringing about stock ownership by all corporate employees . . ."
>
> (Underline added.)

4. WHAT MAKES ESOPs WORK FOR THE CORPORATION AND EMPLOYEE

(A Statement of Principles - June 24, 1985,
By an ESOP Association)

The ESOP Association welcomes the fact that President Reagan and the Treasury Department recognize the benefits of capital accumulation by employees through ESOPs and the use of ESOPs as a technique of corporate finance.

The Association is a professional and trade association whose members have taken steps to ensure that employees accumulate capital through an ESOP. Because of the success of ESOP companies, the Association's experience has shown that these principles are necessary for the continued and future success of tax-qualified plans which hold primarily employer securities in the form of common stock.

These principles are:

1. Capital, in the form of employer's common stock, must be required to accumulate in a trust, and the trustee should be subject to fiduciary responsibilities. Unless the trust plan permits, there should be no required payment or distribution to employees of the employer's common stock other than as provided under current law;

2. Employees should recognize no income on employer securities in the form of common stock accumulating under an ESOP. Following distribution of shares to an ESOP participant, any appreciation of the securities over the trustee's basis should be treated as long-term capital gain upon any sale of the securities.

3. Employers should be encouraged to make annual contributions to the trust, in cash or employer securities in the form of common stock. This encouragement, in the form of deductions for such contributions, should be at a level at least equal to current law;

4. Allocations of employer securities should primarily be based on employees' relative compensation with reasonable limits on allocations to certain highly-paid and/or major shareholder/employees, such as provided under current law;

5. ESOPs and ESOP transactions should continue to qualify for present exemptions under federal and state securities laws. In addition, ESOPs should be regulated under federal law rather than under the laws of the 50 states.

6. After a reasonable period of service, participants' accounts in the trust should become vested in employees on a graduated basis over a reasonable period of time.

7. The tax laws should continue to provide incentives for the establishment of leveraged and nonleveraged ESOPs. Various laws enacted over the past 12 years by Congress and signed by four Presidents have provided important incentives for ESOPs; and

8. In matters of corporate governance, the law should recognize the significant distinctions between publicly-traded corporations and closely-held corporations.

The ESOP Association does not completely agree with the concept that ESOPs are not retirement plans. They can be; they can also be better than normal retirement plans. They can provide employees more wealth, and they assist in corporate finance. Experience with ESOPs over the past 12 years documents this position.

The ESOP Association will work with the Administration and Congress to ensure that the basic principles as set forth above are embodied in the laws of the United States.

Any proposal which is not in accord with these principles will be opposed by the Association.

5. THE CHALLENGE OF THE ADMINISTRATION'S ESOP PROPOSAL

On several points, the specifics of the Administration's ESOP proposal falls short. It falls short on both ESOP theory, and on ESOP economics. And, bluntly stated, it is not a practical proposal in several aspects.

First and foremost, ESOPs are to benefit both the employer-corporation, and the corporate employee.

The Administration's proposal seems to be based on the false premise that ESOPs are to benefit only employees.

Secondly, and more specifically, the Administration proposal recognizes only the leveraged ESOP, whereas past history shows the nonleveraged ESOP, a stock-bonus plan, can provide great accumulation of wealth to employees, and benefit the employer-corporation. There may be valid distinctions between the rules governing the two kinds of ESOPs, but the basic tax treatment of the two kinds of ESOPs should be the same, as under current law.

Thirdly, the following specific proposals in the Administration's ESOP proposal do not measure up to the Association's Statement of Principles. They are:

1. ESOP stock in a leveraged ESOP may not accumulate since an employee is allowed to speculate with the securities in his account, and can also force his employer to repurchase the stock every year.

2. A closely-held corporation with a leveraged ESOP becomes subject to SEC laws and state Blue Sky laws;

3. Gains on employer securities in a nonleveraged ESOP are recognized upon distribution, and taxed as ordinary income;

4. Contributions to a nonleveraged ESOP is limited to 15 percent of an employee's lifetime compensation;

5. Corporate governance in a leveraged ESOP would be governed by federal law, hampering the ability of a corporation to obtain bank financing, and ignoring the realities of governance of a closely-held corporation;

6. Immediate vesting for employees in their accounts in a leveraged ESOP would create a windfall for short-time employees, and create havoc for corporate administrators;

7. A $50,000 cap on the employee's compensation for purposes of allocations and distributions of a leveraged ESOP denies mid-level managers a fair share of ESOP stock;

8. Making a corporation pass through its tax savings on a leveraged ESOP stock dividend kills the incentive to pay such a dividend;

9. Required 5-12 year financing of a leveraged ESOP loan limits the flexibility required for ESOP financing;

10. Refinancing of existing leveraged ESOPs are covered by new proposed rules instead of being grandfathered;

11. Nonleveraged ESOPs are not eligible for incentives encouraging the accumulation of capital for employees;

12. The number of employees in a leveraged ESOP must be greater than 15;

13. Leveraged ESOP loans may purchase only "outstanding" shares of employer securities;

14. The incentive for certain estates to transfer employer securities to an ESOP would be eliminated; and

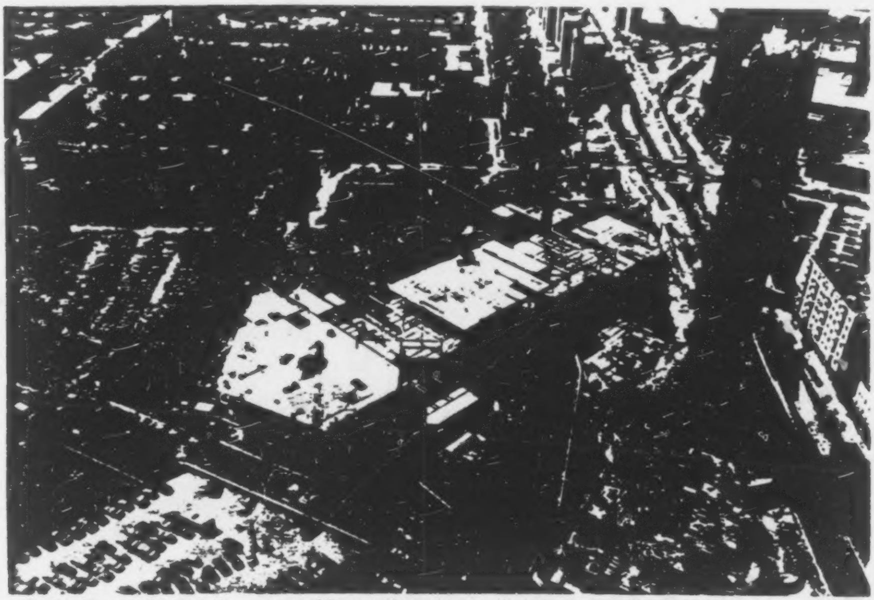
15. New nondiscrimination rules may make it difficult for larger companies to establish and maintain a nonleveraged ESOP.

·PROFILE·

THE EMPLOYEE STOCK OWNERSHIP ASSOCIATION OF AMERICA • 1725 DeSales St. NW Suite 400 Washington DC 20036 202-293-2971

Perini Corporation Profile

When Italian immigrant Bonfilio Perini established a construction company in the late 19th century, he could never have imagined that the company he began would reach the tremendous proportions which constitute the present day Perini Corporation. Not long ago it would not have seemed any more likely that Perini employees would own an important stake in the company. Yet today employee ownership forms a central part of the Perini management plan which seeks to further develop and motivate Perini's prime resource — its employees. As part owners of the company, those employees are learning that they can share in a big way in the future successes of the Perini Corporation.



Copley Place in the Back Bay section of Boston, Massachusetts. Perini's responsibility in this $500 million development included construction of the foundations and roadways in addition to the completion of the central office and shopping section.

An international construction and real estate development company with nearly $1 billion in annual sales, the Perini Corporation today employs over 1000 people in their corporate division and 10,000 to 15,000 people at various sites around the world. Major Perini projects include the development of industrial and commercial sites and construction of oil pipelines, power generation and waste treatment plants, as well as mass transit systems, shopping malls, hotels, medical centers and sports complexes. Real estate development in several growing areas of the U.S. and a coal mine in West Virginia have also contributed significantly to Perini operations.

Employee Motivation

At a company in which so much of the operations are service oriented, keeping good people is critical to the company's success.

David Perini, Chairman, President and CEO of Perini Corporation, says of his company's ESOP: "We became convinced of the merits of having employees own a major share of the company just as the Perini family does."

Company President David Perini attributes the success of the corporation largely to their ability to recruit highly qualified personnel, and to provide a business environment which allows employees to develop to their optimum capabilities. That philosophy led naturally, in Perini's eyes, to the formation of the Perini employee stock ownership plan in 1982.

"An ESOP is ideal for us," says Perini. "In a people oriented business the more motivated the workers, the better the health of the company." Though the company already had an employee pension plan and a profit sharing plan, the Perini management felt that sharing the ownership of the company with the employees would help make them better aware of the direct link between their individual performance and the overall success of the company by allowing them to share in that success. They thought that by giving workers a stake in what is already a successful and highly profitable business, the company would be in a better position to attract and keep highly qualified workers.

An Idea in the Works

Though the ESOP wasn't installed until 1982, Perini's management had been aware of the ESOP concept well before that time due to the influence of a former corporate secretary and Board member named Louis Kelso. Kelso, a prominent San Francisco attorney and economist who originated the ESOP concept, had promoted his ideas for employee ownership in the early 1960's when he worked with the company. It wasn't until the late 70's, however, that his ideas began to take root in the thoughts of Perini's management.

Since 1957 Perini has been develop
completed project includes shopping cen

"We considered an ESOP for several years before we actually installed the plan," says David Perini. "We became convinced of the merits of having the employees owning a major share of the company just as the Perini family does, and we think it has

4000 acre tract within the city limits of West Palm Beach, Florida. This largely
partment complexes and golf courses.

excellent long term potential for improving the overall strength of the company."

The Perini ESOP

The Perini ESOP, in conjunction with a PAYSOP, forms the center of an employee benefits package which includes a profit sharing plan and a defined benefit plan. The ESOP currently owns 10% of the company. According to Bob Higgins, Perini's Vice President and Tax Counsel, that figure will increase to 13% as the company divests itself of shares they currently hold from a Perini subsidiary which was recently spun off. Higgins says the company has been making contributions to the plan at the rate of 25,600 shares per year, or 10% of the value of the original ESOP loan. That rate of contributions will remain constant until the original loan is retired.

About 1000 employees who comprise the corporate staff are eligible to participate in the ESOP. Workers engaged on specific projects are not included in the plan. Eligible employees who are at least 25 years of age qualify for participation in the ESOP after one year of service. After five years participants are 25% vested. That figure increases at the rate of 5% per year until 100% vesting is reached at the end of fifteen years.

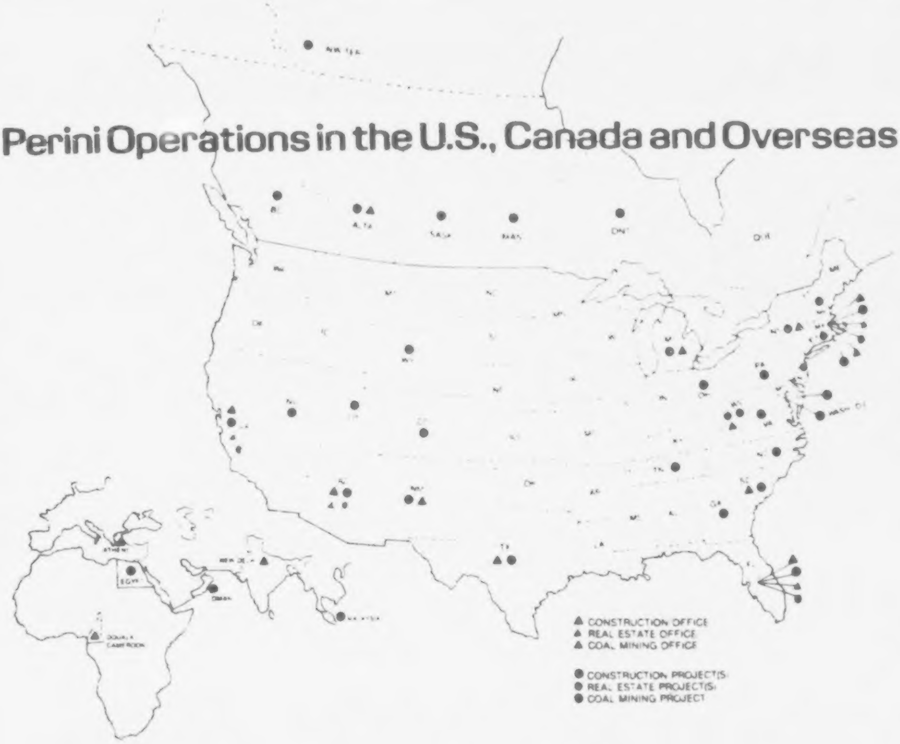
Communications

To communicate the ESOP concept to their employees, the company developed its own film which provides a brief history of the company and explains the general features of the plan from eligibility requirements to how the company makes contributions to the ESOP trust, vesting schedules and what factors determine the value of Perini shares.

Participants to the plan also receive quarterly stockholder reports from company President David Perini. In addition to those letters, Perini also travels to the six regional centers across the country that form the Perini network of operations to speak to employees about their role as employee/owners and about the company's projects. Annual reports are issued to each plan participant informing them of the value of their accounts.

Employees have been very receptive to the plan and Perini feels confident that the ESOP will be a big plus for the company. It seems that Louis Kelso was on to something after all.

Perini Operations in the U.S., Canada and Overseas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Mr. Warren L. Braun
ComSonics, Inc.
P. O. Box 1106
Harrisonburg, VA 22801

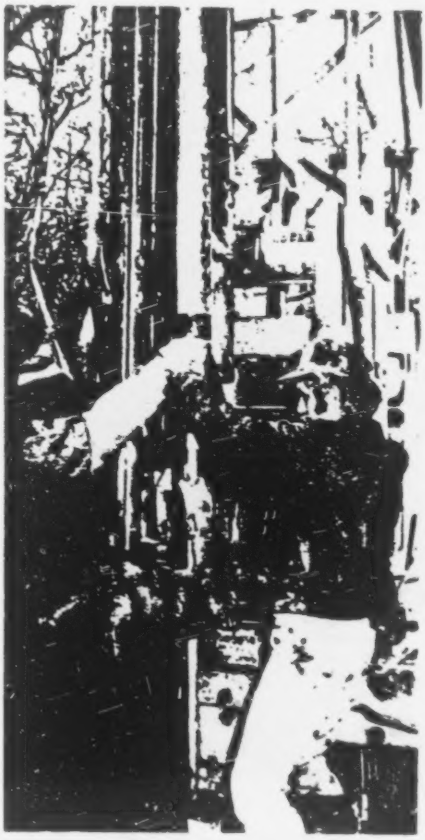
March 1985

•PROFILE•

THE EMPLOYEE STOCK OWNERSHIP ASSOCIATION OF AMERICA • 1725 DeSales St. NW Suite 400 Washington DC 20036 202 293-2971

Harco Corporation

Out of sight certainly doesn't mean out of mind for the employee/owners of Harco Corporation. Harco is the largest supplier of cathodic protection systems in the country but don't be surprised if you have never seen their products. Few people do since most of their work is buried underground or underwater. Harco designs and produces cathodic protection systems to prevent corrosion of metal structures or structures containing metal. Cathodic protection systems are commonly designed for such diverse structures as oil and gas pipelines and storage tanks, undersea piping, airport fuel lines, offshore drilling and production platforms, locks and dams, reinforced concrete and building structural supports, to name a few. Virtually every type of metal structure buried or submerged in harsh environments throughout the world needs protection against corrosion. Harco provides comprehensive cathodic protection services which include the fabrication of anodes (the workhorse in any cathodic protection system), engineering and design of complete cathodic protection systems, surveying, installation and maintenance and repair of existing systems. In addition, consulting services are provided for any aspect of cathodic protection to help ensure a long life for metal structures.



Harco employees at work installing some of the firm's cathodic protection systems. All of Harco's employees are able to participate in the company ESOP upon meeting minimum eligibility requirements.

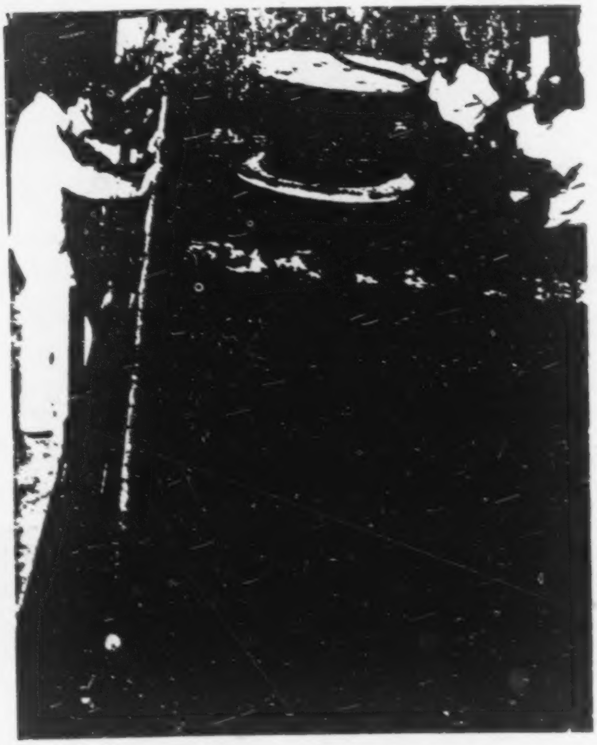
The Development of Employee Ownership

Harco was founded in 1948 but has achieved its most significant growth since becoming partially employee owned in 1971. At that time a group of 20 employees bought the firm from the original owner. That original buyout was achieved with the help of an outside financier who bought 45% of the company. Company sales more than doubled from $4 million to $10 million per year in the three years following the initial transfer of ownership. When the firm was considering how to fulfill its obligation to buy back the 45% ownership share from their "white knight" financier, an ESOP was a logical option. Since ownership had such dramatic results with only a small portion of the employees owning stock, management felt that broadening the base of ownership to include all the Harco employees had the potential for yielding even better results.

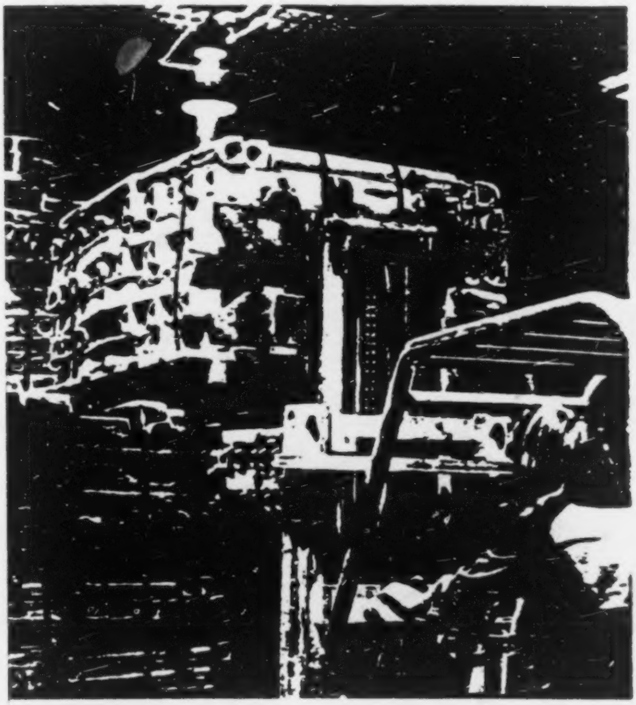
The idea of an ESOP buyout came about when Joe McDade, Harco's President at that time, saw the television show "60 minutes" which featured Louis Kelso, the originator of the ESOP concept. A later interview with Kelso set in motion Harco's ownership change. The change was affected by having the outside investor put his shares in the ESOP and the company used its annual contribution to the ESOP to retire the loan.

"I think the ESOP helps us attract qualified people to the company."

The ESOP took effect in November of 1976. Strong company growth continued. The ESOP paid off its debt in five years and now owns outright a 45% share of the company. Major shares of the company are still owned by the 20 employees who helped buy the firm from the original owner. Ron Langos, Harco's Vice President of Finance, says that the ESOP's share of the company could increase to as much as 70% as the trust buys back the shares from departing employees over time.



Harco company publicity: "We are employee owned. We care."



Company profits have increased steadily since Harco has been an employee owned company.

How It Works

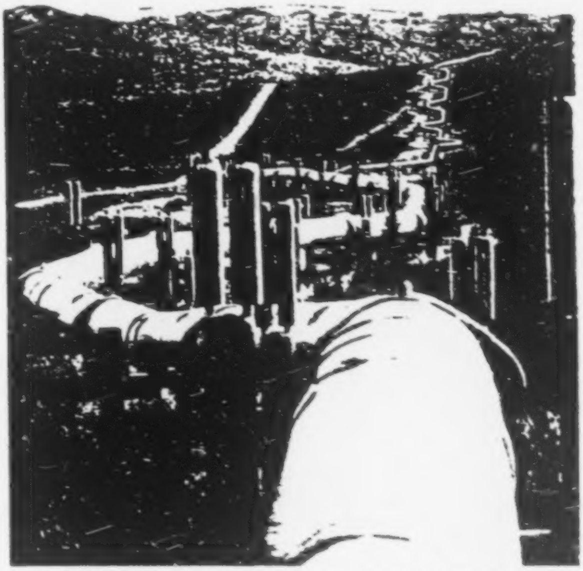
Administration of the company's ESOP is done entirely in house. Manager of Human Resources, Lanise Weidle, oversees administration of the plan at the direction of Harco's ESOP committee which is composed of two officers and three non-officers of the company who serve three year terms. The committee meets every three months and they vote the ESOP's shares at the firm's annual meeting.

The Harco ESOP is augmented by a 401(k) retirement and savings plan whereby voluntary contributions by the employees to the plan are generally two thirds matched by company contributions. ESOP contributions are made by the company at no cost to the employee. Harco has 350 full time regular employees and approximately 100 seasonal employees. All employees become eligible for participation in the ESOP upon completing the minimum requirement of working 1000 hours in a consecutive twelve month period. Harco's ESOP currently has 253 participants and 191 employees who are working toward their eligibility requirements.

Upon termination of employment, employees must wait for a one year break in service before becoming eligible for the payout from their account. Once the annual company valuation is conducted, a departing employee is given the choice of receiving cash payments for the value of the shares in his or her account, or an option to receive their distribution in whole shares of Harco common stock. Cash payouts are generally made in lump sum on accounts up to $2,500, or one fifth of the total due until the balance is paid off. Retirees are given full payment in one lump sum.

A Harco employee/owner testing underground cathodic systems.

Harco's cathodic protection systems have an application for a wide range of metal products including common urban structures



and a variety of more specialized structures such as oil and gas pipelines

Employee Motivation

That the ESOP is important to the company is evident by the fact that Harco's promotional material includes the statement: "We are employee owned. We care!" According to Ron Langos, part of the company's steady growth is attributable to the fact that employees share in the profits the company makes. Despite the fact that in 1984 a group of Harco's management team left to form a rival firm, the company has remained strong. The pride of ownership and the opportunity to grow with a productive and profitable company has helped Harco employees maintain the firm's preeminence in the cathodic protection industry.

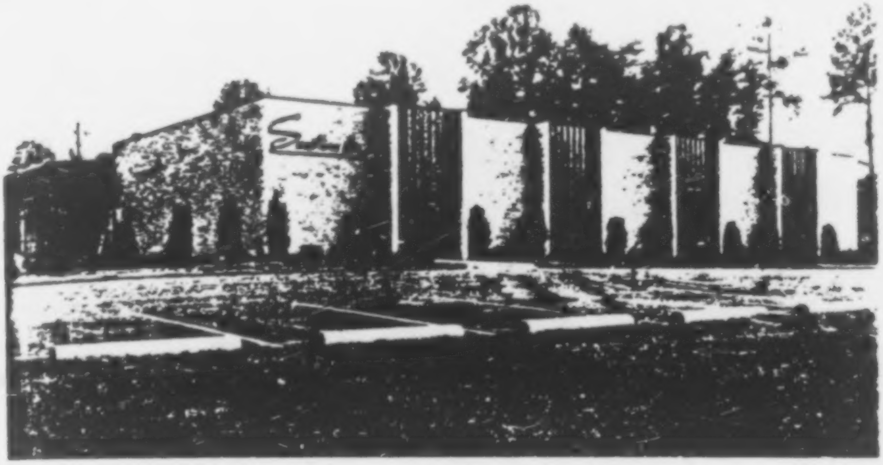
"We have plenty of room for improvement in communicating the ESOP concept to our employees," says Langos, "but I think the ESOP helps us attract qualified people to the company. We have enjoyed steady growth in the past with employee ownership and we want to make all our employees aware of the excellent benefits an ESOP provides, particularly as the company continues to grow."

With foreign operations accounting for 10-15% of its business, and with offices in 18 major U.S. cities, Harco is well positioned to continue its growth rate which resulted in sales last year of over $40 million. As the company prospers, so will the individual workers whose ESOP accounts will grow along with the company. Harco workers thus have a compelling reason to care about their work because they own the company, and as owners they can share in the success they help create.

April 1985

•PR ESOP FILE•

THE EMPLOYEE STOCK OWNERSHIP ASSOCIATION OF AMERICA • [illegible] NW [illegible] Washington DC [illegible]



Southern Air Headquarters on Lakeside Drive in Lynchburg, Virginia

Southern Air, Inc.

The seasonal winds may blow hot and cold in Lynchburg, Virginia, but attitudes of Southern Air Corporation's employee owners always remain constant. The reason? The knowledge that their company is a winner. Since its inception in 1946, Southern Air has developed a superior reputation in the heating, air conditioning, plumbing, electrical design and contracting business in the South Central Virginia region. Certainly, that image is clearly reflected in the exponential revenue growth which they have experienced, increasing from $250,000 in 1946 to $13,000,000 in 1984.

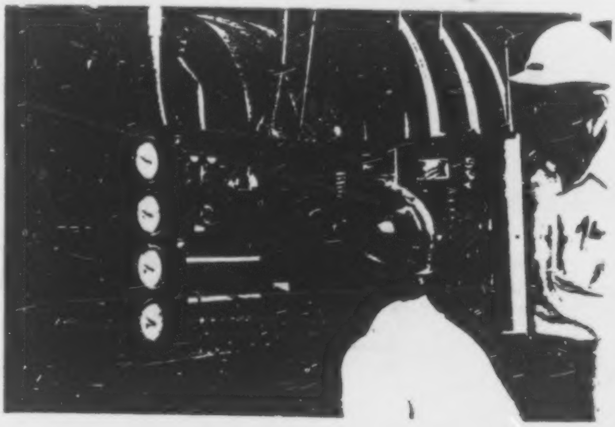
Locally, in Lynchburg (population 160,000) Southern Air dominates the all purpose contracting market; regionally they are recognized as one of the top 2 or 3 mechanical and electrical contractors. The formula from which this record evolved is surprisingly simple. Southern Air has always focused intently on detailed planning and then completely followed through on those designs. Yet, they have also demonstrated

Southern Air's Board of Directors (from left to right) Secretary Neville Rowland, Treasurer Bob Waugh, President Bob Clarke, Chairman of the Board George Costan, Vice President Brady Williamson, and Vice President Jim Burr.

an ability to be flexible and to be among the first to incorporate state-of-the-art technological advancements into their projects. When a company builds on a solid foundation such as this and at the same time keeps a clear vision of the future, its employees develop a sense of loyalty and that pushes the company to prosper. But Southern Air remained vigilant in its quest to improve its company/employee relationship too. This same forward-thinking, business approach was employed by its management and spilled over into their attitudes toward the company's labor force, creating what many industry insiders consider to be a remarkable record. Bob Clarke, President of Southern Air since 1976, cites the fact that, "Our employees here have always had good attitudes and we realize how important that has been. We've been rewarded by having some of them stay for 25-30 years. This is unusual in the construction industry."

That awareness and true appreciation led to the installation of the company's ESOP in 1983. "We did have an established profit sharing plan in place since 1973, but we were not satisfied with it. We put the ESOP in to help attract employees and improve benefits and it has worked."

That 1983 decision brought about a fresh start. All profit sharing funds were rolled into Treasury bills and notes and frozen. The new contributions that followed went directly into ESOP stock. The conversion to an ESOP company brought about other major advantages for Southern Air, too. By making that move, they gained control of their company's securities investment performance while adding a tool to aid growth. "With earnings being reinvested into the company, we have available more funds for capital formation purposes. Also, our stock has easily outperformed the profit sharing investments — which were in mutual funds, the stock and bond markets. The companies that had given us investment advice for profit sharing lost money each year. By investing in the company's stock, our total rate of return should be 15% or better a year. We got out of the speculative markets and into the market that we know. Overall, we're more comfortable with the ESOP investment and more sure of its performance."



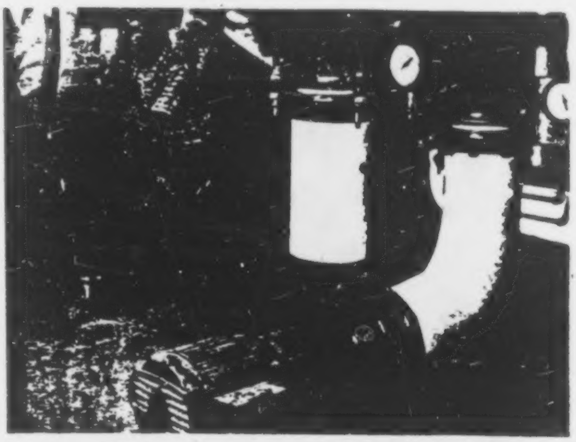
Southern Air's Bob Waugh and Ward Sayre inspect the wiring on a centrifugal chiller at the Nationwide Insurance Offices in Lynchburg.

Capital Formation at Southern Air

The passage of the 1984 tax bill, which contained the most sweeping changes and incentives for ESOP plans in their short history, spurred a dramatic upsurge in interest at Southern Air for possible future use of their ESOP for expansion.

"That 1984 Tax Act has made borrowing under the ESOP mighty attractive. If we do decide to finance a project, we know that provision is there and we'll get a good rate. I would think that is an added incentive for any company considering an ESOP," Clarke continued.

But Clarke doesn't believe that in the near term Southern Air will need to be in the market for debt financing. The company has enjoyed an average revenue growth rate between 20% and 25% for each of the last five years. That prosperity teamed with a building reserve of ESOP assets should provide a healthy cushion. "Certainly the company has grown. I think a good part of that growth came about because management has been willing to share stock ownership with employees." Clarke, however, does not rule out possible use of the ESOP reserves in the long term, as it is difficult to predict the rate at which the company may expand. If need be, the ESOP fund would be a perfect instrument for Southern Air to utilize. "Although we didn't set the ESOP up for that purpose, it is another option to consider. We will use the ESOP for capital expansion if we think the time is right."



A Southern Air technician services a large air handler as part of a routine maintenance program

Bonus Program

The birth of Southern Air's ESOP has given further impetus to the implementation of another cost-cutting, profit incentive program. The company recognized early on that the ESOP initiative increased productivity. Why, they questioned, can't we increase productivity further, thus aiding the company ESOP even more? It then dawned on management to plug that theory into the areas with the most variables — the job estimate. The arrangement that resulted was the Bonus Program, wherein if the labor costs on a project came in under estimate, approximately 40% to 50% of those savings are directly allotted to the participants in that project. Clarke maintains that this program has been very beneficial. "We're all working together. Many are extremely interested in this idea. Employees are now concerned with waste. If there is an area to save some money, their attitude is any funds saved on this project will effect the value of ESOP stock, which is based on our earnings, our assets and on growth." At the same time, the outline for the Bonus Program demands that the standards which have brought Southern Air to enjoy their good reputation and continual growth be maintained. "This program cannot affect the quality of our work, we have a reputation of doing *quality work* and this *must not* change."

Communications

When Southern Air established its ESOP, they immediately confronted a common problem — how best to communicate ESOP news to the employee/owners. Their first effort at communicating gave them a clue as to what they didn't want to use as a standard method. Bob Clarke stated, "Of course we were very enthusiastic about the communications aspect when it was established. We called a company-wide meeting and everyone came. But we quickly realized that to get a meeting together on a regular basis is very tough and very expensive. The company loses a lot of money in downtime, particularly when the workforce can be anywhere from 100 to 150 miles away."

> *"Most people who work at Southern Air are very happy to own a piece of the company and certainly want to own more ..."*

To combat the communications problem particular to Southern Air's disbursed workforce, management decided that it would be more cost-effective and efficient to publish a monthly newsletter. The employees were asked to participate in a contest in which they were to choose an appropriate name for their bulletin. After some deliberation, *The Stockholders Report* garnered a consensus. It is now mailed to the workers' home 12 times a year, giving continuous updates on the ESOP's performance in addition to other financial and job-related news. "This newsletter keeps them informed and I think the feedback that we have received indicates that they are comfortable with it," Clark commented.

Future at the Southern Air ESOP

Southern Air's history and most recent company-wide performance bodes well for the future. Many of the workers feel that the emergence of the ESOP further solidifies the loyalty that has been built up over the years. "Most people who work at Southern Air are very happy to own a piece of the company and certainly want to own more," Clarke says.

That attitude can only spell further success for the apprentice workers as well as those soon to retire. "The ESOP helps to guarantee that the company will continue. I would like to see the cash accumulate in the ESOP. If someone wants to retire, stock then could easily be purchased. We of course hope to have younger people come in and participate."

The Southern Air employee owners and its ESOP seem to feed off each other, with the result being a more productive, wealthier and contented workforce. And the ESOP program is really in its infancy. Clarke says, "Face It. Down the road, it will be the employees that will win. They realize it's a team effort. We'll all share from the profits of teamwork. You know, before the ESOP was installed, an employee who was working alone down in a dark cellar might question why he was doing it. Now if he was faced with the same situation, he'd know why."

• THE BASICS •

Name:	Southern Air Incorporated Employee Stock Ownership Plan
Year established:	1983
Percent of Company owned:	5%
Type of plan:	ESOP, PAYSOP
Plan investments:	Treasuries (from former profit sharing plan); all new investments in company stock plus cash.

June 1985

·PROFILE·

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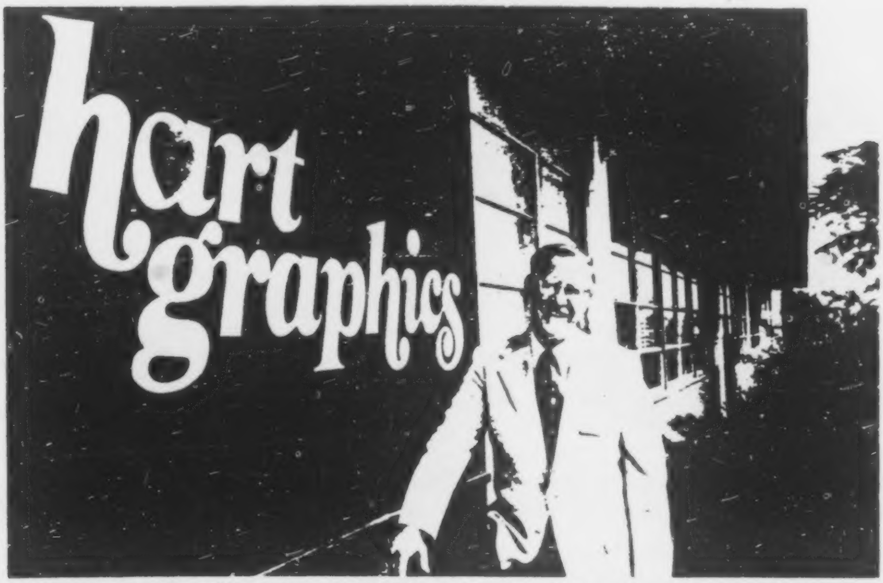
Hart Graphics



Bill Hart, President of Hart Graphics. ESOP financing allowed his company to survive and prosper.

The Hart Graphics ESOP story is common among ESOP companies. A story involving a bank loan to fund employee stock contributed to an ESOP that literally saves the company. And after a few years, the company is *very* successful

Unfortunately, this kind of ESOP story does not make the national press, but it is the kind of ESOP story that needs repeating over and over. This is particularly true in view of the President's ESOP proposal which would discourage a company like Hart Graphics from ever setting up an ESOP.

Hart Graphics is a printing company in Austin, Texas. Although the name Hart Graphics dates only to January, 1974, the corporate predecessors date to 1912, when the company was The Steck Company and later Steck-Warlick Company.

From 1912 to 1962, The Steck Company was a conservative, home-owned, profitable printing and office supply company. In fact, Steck was one of the three largest printers in Texas.

In 1962, things changed, and in a big way. The company was acquired by an investor-owner, who owned 100% of the stock. The company was re-named The Steck-Warlick Company.

The new owner changed the company's direction by acquiring another printing company in Dallas and a typesetting company in Houston, and building two new printing plants in Dallas and Houston, where the owner wanted to concentrate Steck-Warlick's efforts. The financing for these expansions was mainly with bank loans.

The new owner was also the largest single stockholder in the bank making the loans.

But things were not going well. In 1968, Steck-Warlick lost $1,000,000 on $15,000,000 in sales. Although losses were cut in 1969, by 1973, Steck-Warlick's debt had increased 500% and they had breached their loan agreements. The Austin operation was at the bottom. The number of Austin employees had dropped nearly 40%. Forty percent of the sales had moved to Dallas. Austin operations were in the red. There was little, if any, positive employee morale.

Nevertheless, in Austin, there were dedicated people, skilled craftsmen, some profitable product lines, many loyal customers, and a variety of old, but productive, pieces of equipment. These dedicated employees felt that they could turn the situation around.

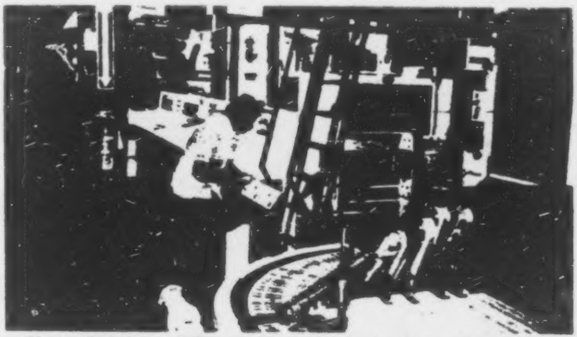
The investor-owner would not sell the company to employees, but he would sell to a single, and responsible, employee.

That employee was Bill Hart. He bought the building lease, the inventory, the fixed assets, a union contract, 292 employees, 10,000 active customers, and $100,000 in cash. He paid $1000 in cash, and signed a note for $1,600,000, payable at 2½ points over prime, interest only payable for the first three years, $160,000 in principal plus interest in years 4 through 9, with a $500,000 balloon payment due in year 10.

The loan agreement put a ceiling on salaries, pledged Bill Hart's personal assets as collateral, restricted dividends, stock sales, acquisitions, sales, and mergers. Minimums were set for working capital, current ratio, ratio of debt to assets, and other financial ratios. The seller expressed the opinion that the note would be in default in six months.

Hart Graphics was born under these trying circumstances on December 7, 1973 — Pearl Harbor Day.

Bill Hart, President of Hart Graphics, says, "Every step taken after December 7, 1973, was either to satisfy the bank or influence the bank." (Policy-



Hart Graphics follows the theory that knowledgeable employees are better employees. The value of ESOP accounts, how the company is performing, and the valuation of the ESOP shares is fully communicated to the employees.

makers in Washington who try to dictate to ESOP companies on issues of corporate governance should recognize that a lender often has more power than stockholders, and frequently key decisions are dictated by loan terms.)

Dark Days

In June 1974, Hart Graphics' cash flow situation was bordering on disaster. But extra work pulled the company through.

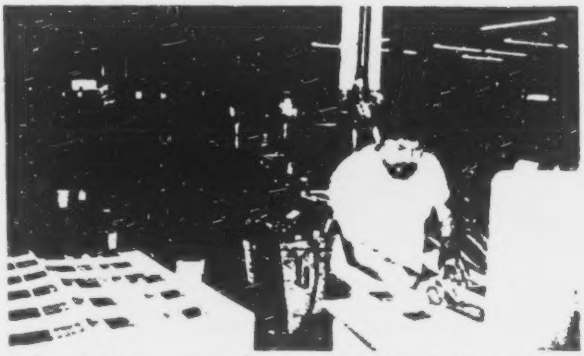
Then the 1975 recession slowed business, and by 1976, Hart Graphics wanted to refinance its original note with the prime owner, plus continue the original line of $800,000 bank credit. This meant a bank would have to agree to an $800,000 long-term note to refinance, as well as the $800,000 line of credit.

And even though Hart Graphics had weathered hard times, and shown a modest profit on sales of nearly $8,000,000—the bank said NO!

ESOP Financing Makes the Difference

Bill Hart had read Louis Kelso's writings on "Two-factor Economics" because his brother had sent them to him.

He was impressed with Kelso's theories, and decided to put them to work. He and Hart Graphics' financial officer, Areta (Sunny) Jones put together a financing package utilizing a non-leveraged ESOP.



Hart Graphics employees have weathered hard times, but their perseverance has paid off. The value of their ESOP stock has increased 630% from 1976 to 1985.

Because his proposal improved the ability of Hart Graphics to service debt, the bank reversed its previous position and agreed to provide new financing.

On July 1, 1976, the Hart Graphics, Inc. Employees' Stock Ownership Plan was created.

Things have never been the same since for Hart Graphics—they have been much better!

The ESOP

Hart Graphics ESOP does not include employees under a collectively bargained agreement. They have accounts in a profit-sharing plan, and are part of a multi-employer pension plan.

Approximately 250 employees are eligible to participate in the ESOP. Vesting is 25% after 4 years of service, with 100% vesting after 15 years.

The ESOP holds 13% of the Hart Graphics stock, which is not publicly-traded.

Hart Graphics follows the theory that knowledgeable employees are better employees.

Thus the value of ESOP accounts, how the company is performing, and the valuation of the ESOP shares is fully communicated to the employees. The annual meeting emphasizes full discussion.

On several occasions, Areta Jones has heard an employee covered by the union pension plan express envy that his or her spouse is part of the ESOP. And this envy is well-founded because Hart Graphics sales have increased nearly 8 times over in approximately ten years.

In the latest fiscal year sales were $40,000,000 compared to $5,000,000 in 1974. And even more impressive, since the 1976 transaction creating the Hart Graphics' ESOP, the value of the shares of Hart Graphics stock held by the ESOP have increased by 630% from 1976 to 1985!

Hart Graphics Leads the Charge for ESOPs

But Hart Graphics has not enjoyed its success and forgotten its duties as a corporate citizen.

Hart Graphics has taken the lead in showing its Congressman the importance of ESOP financing. Because its Congressman, J.J. Pickle of Austin, Texas, is a senior Democrat of the tax-law writing Committee on Ways and Means, the whole ESOP world owes Hart Graphics a big thank you.

It is a tribute to Hart Graphics that when Congressman Pickle spoke to the Eighth Annual ESOP Convention, he expressed his admiration of Hart Graphics.

The Congressman does not admire Hart Graphics and Bill Hart because of political connections, (in fact, the Congressman, a Democrat, noted Bill Hart was a Republican) but because he respects what a strong, successful, closely-held company like Hart Graphics can do for a community.

After visiting the Hart Graphics plant in 1980, Congressman Pickle observed, "You must have the best spirit between employees and management that I have ever seen."

If other members of Congress could say the same thing about ESOP companies in their districts, then ESOPs would never face negative legislation in Congress.

Conclusion

The Hart Graphics story is common in the ESOP world. The story of a small, closely-held company under new management, using the ESOP financing tool to turn the corner. And once the corner was turned, the road ahead was paved with success.

But, the public and Congress do not know about these ESOP success stories. The Association cannot tell the story effectively. Like Hart Graphics did, the story has to be told by the men and women who experienced firsthand what an ESOP can do.

Only then will the ESOP story literally come home to where it is most effective.

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April 1985

·ESOP·REPORT·

THE EMPLOYEE STOCK OWNERSHIP ASSOCIATION OF AMERICA • 1725 DeSales St. NW Suite [illegible] Washington DC 20036 202 293 [illegible]

Congress, Media Increase Scrutiny of ESOPs

Events in recent weeks have raised ESOPs to a new level in public policy debate. ESOPs figured prominently in hearings on leveraged buyouts held by the House Ways and Means Committee, and major stories on ESOPs and employee ownership appeared in several national publications. Those events, along with proposals to eliminate ESOP tax incentives in the interest of tax reform, have drawn increasing attention to the impact that employee stock ownership is having on our national economy.

Hearings held in April by the Subcommittee on Oversight of the House Ways and Means Committee focused on leveraged buyouts. Ronald Pearlman, Assistant Secretary for Tax Policy in the Department of Treasury, called on Congress to examine the consequences of increased use of leveraged ESOP buyouts as a defense against hostile takeovers. Pearlman criticized ESOPs on the grounds that they "may have an unnecessary dampening effect on otherwise advisable mergers." The use of ESOP LBO's was defended by Congressman Beryl Anthony (AR) who said that the likelihood of greater use of ESOPs "shouldn't be cast in a negative light" since ESOPs helped address the problem of the concentration of stock ownership. Association member Joe Schuchert of Kelso & Co. also testified before the subcommittee to defend the use of leveraged ESOP buyouts as an effective means of transferring equity ownership to employees.

The recent media coverage helped to raise the profile of ESOPs but perpetuated several misconceptions about employee ownership as well. Despite describing ESOPs as "a remarkable force" that is "sweeping corporate America" and predicting that fully one fourth of the national workforce may be part of an ESOP within 15 years, the April 15th *Business Week* cover story on ESOPs ("Revolution or Ripoff?") was critical of the use of leveraged ESOP buyouts. An op-ed piece published by the *Wall Street Journal* was also critical of ESOPs and endorsed the elimination of the 1984 ESOP tax provisions as recommended by the Treasury Department. The April cover story of *Inc.* magazine ("In Search of

(continued next page .)

Association Member Company Wins Productivity Award

Warren Braun, President of ComSonics, Inc.

ComSonics, Inc., a Harrisonburg, VA firm that produces cable television and satellite communications equipment was awarded the U.S. Senate Productivity Award given each year by U.S. Senators Paul Trible and John Warner. The award is given to the Virginia manufacturing company with the best program for encouraging workers to produce.

The company was cited for its employee ownership and management program. The ComSonics ESOP currently owns 48% of the company. Employee attitudes were what impressed the five-person committee which visited the plant early this year and decided that ComSonics merited the award.

Company President Warren Braun, who is also Executive Vice President of the ESOP Association, noted that workers have a strong voice in company decisions by virtue of monthly departmental meetings with managers and supervisors. Those exchanges have produced ideas which have lead to the development of sixteen different patents for the company.

... Scrutiny of ESOPs (cont.)

Equity") was much more favorable, siting the growth in the number of ESOPs as a sign of "where the future is coming from."

Though the increased publicity is welcome as a way of bringing the ESOP message to more companies, it is vitally important that misconceptions about ESOPs and employee ownership be rectified. The *Business Week* editors may be correct in stating that "the ESOP trend is at a turning point" and decision makers need to hear the positive side of employee ownership. In light of the fact that the cost of ESOPs to the federal government in deferred tax revenue for fiscal year 1986 is $2.5 billion, ESOPs are sure to attract the attention of politicians looking for ways to reduce the federal deficit. The ESOP Association must aggressively communicate the fact that ESOPs provide benefits that more than compensate for the concomitant loss in federal tax revenues.

Congressman Beryl Anthony (AR) The likelihood of increased use of ESOP leveraged buyouts "should not be cast in a negative light."

The most fundamentally powerful argument for ESOPs is in their ability to raise employee earnings through the second income that ESOPs provide. Approximately 1% of the population currently owns 48% of the common stock in the country. ESOPs are addressing that equity ownership imbalance and allowing workers the chance to share in the growth of capital formation. Tax incentives for ESOPs are defendable on the grounds that broad ownership of capital is sound economic policy and that more companies should be encouraged to share ownership with their employees.

Other advantages such as increased worker motivation and productivity, the fact that ESOPs can be used to raise capital with the ability to deduct both principal and interest on loan repayments, and the rollover provisions encouraging owners of privately held firms to sell stock to an ESOP need to be communicated. ESOPs may well be at a turning point and extra effort on the part of ESOP companies is essential if the movement for employee ownership is to succeed. This month's Washington Report by Association General Counsel Michael Keeling underscores the importance of a grass roots lobbying effort to help get the ESOP message to our country's leaders. All Association members are urged to join the effort.

Central America ESOP Bill

An amendment promoting the use of ESOPs in Central America, reported in the March *ESOP Report*, has now been passed by the Senate Foreign Relations Committee and the House Foreign Affairs Committee. The amendment will be considered by the full House and Senate as part of the 1985 Foreign Aid Bill.

Both amendments state that employee stock ownership plans can be an important instrument for achieving United States goals in Central America and the Caribbean, which include the finance of growth and equity transfers to expand political and economic pluralism. The amendments also urge the President to develop a plan for expanded ESOP use in U.S. development efforts in Central America. By enacting policy and infrastructural changes, regional multinational corporations and private sector firms with major financial stakes in the region would be encouraged to initiate employee stock ownership plans.

The Senate amendment also calls for the establishment of a Presidential Task Force which is to be supported without the use of public funds. They will be charged with the task of preparing specific recommendations and strategies to stimulate the spread of ESOPs with an eye towards accelerating the rate of Central America private sector capital formation that is systematically linked to expanded ownership opportunities for all employees.

1985 ESOP Survey Results

The final results of the 1985 ESOP Association Survey of regular company members have been tabulated. A total of 239 companies responded to the survey which was meant to assess how ESOPs are used in actual practice.

Survey highlights:

- 56% of the companies claimed that worker motivation and productivity were "somewhat improved" as a result of sharing stock with employees through the ESOP. 16% indicated "strongly improved" performance.

- On the average, ESOPs own 33% of the company stock. Respondents estimated that the percentage of ESOP ownership would grow to an average of 48% over the next five years.
- A majority of companies offer additional employee benefits other than the ESOP. Most common is a defined benefit plan which is offered by 34% of the companies.
- Fully one third of the companies have leveraged their ESOP.
- Only 3% of the ESOPs required wage concessions by the employees.

Association members will receive one copy of the complete survey at no charge. Additional copies are available for $5.00 from the Association office.

Convention Travel Discount

The ESOP Association has arranged a special discount airfare for members who will be attending the annual convention on May 15-17 in Washington, DC. By calling a toll-free number at Eastern Airlines and giving the ESOP Association access number, Association members will be extended a minimum discount - no restrictions - of 30% off a normal coach fare.

You must give the access number in order to qualify for the 30% discount. The number for the ESOP Association is EZ5-AP21.

The number to call at Eastern Airlines to make your reservations is 1-800-326-1295. In Florida call 1-800-432-1217.

Washington Report

by Michael Keeling

A common line in Grade B movies of the 30's was the police dispatcher's "Calling all cars! Calling all cars!"

Your association is now "Calling all ESOP companies! Calling all ESOP companies!

Or more bluntly, "We need *your* help!

The House Ways and Means Committee *will* start work soon on a major tax reform bill. The Chairman of that committee, Representative Dan Rostenkowski, has said "Everything is on the table." "Everything" includes ESOPs.

The Association has solid intelligence that the Treasury Department's proposal to eliminate *all* ESOP incentives has support among certain tax staff people of the Congressional tax committees.

The bottom line is this - if the Congressmen serving on the House Ways and Means Committee do not believe ESOPs are sound policy, then there is a high probability that the Committee will agree with the Treasury and eliminate ESOP incentives.

Working together, we can prevent such a drastic action.

Below is a list of the members of the House Ways and Means Committee, their home town and/or the major city in their district, and the number of their Congressional district:

Dan Rostenkowski, Chicago, 8th IL
Sam Gibbons, Tampa, 7th FL
Jake Pickle, Austin, 10th TX
Charles Rangel, New York City, 16th NY
Pete Stark, Oakland, 9th CA
Jim Jones, Tulsa, 1st OK
Andy Jacobs, Indianapolis, 10th IN
Harold Ford, Memphis, 9th TN
Ed Jenkins, Jasper, 9th (NE) GA
Richard Gephardt, St. Louis, 3rd MO
Tom Downey, Islip, 2nd NY
Cec Heftel, Honolulu, 1st HI
Wyche Fowler, Atlanta, 5th GA
Marty Russo, Chicago, 3rd IL
Frank Guarini, Jersey City, 14th NJ
Donald Pease, Lorraine, 13th OH
Beryl Anthony, Pine Bluff, 4th AR
Ronnie Flippo, Huntsville, 5th AL
Byron Dorgan, at large, ND
Barbara Kennelly, Hartford, 1st CT
Brian Donnelly, Boston, 11th MA
William Coyne, Pittsburgh, 14th PA
John Duncan, Knoxville, 2nd TN
Bill Archer, Houston, 7th TX
Guy Vander Jagt, Muskegon, 9th MI
Phillip Crane, Chicago, 12th IL
Bill Frenzel, South Twin Cities suburbs, 3rd MN
Richard Schulze, Western Philadelphia suburbs, 5th PA
Bill Gradison, Cincinnati, 2nd OH
Henson Moore, Baton Rouge, 6th LA
Carroll Campbell, Greenville, 4th SC
Bill Thomas, Bakersfield, 20th CA
Raymond McGrath, Garden City, 5th NY
Hal Daub, Omaha, 2nd NE
Judd Gregg, Nashua, 2nd NH

If you live in any one of these Congressional districts, if your company is located in any one of these Congressional districts, or if any of your employees live in any one of these Congressional districts, please contact David Binns, or Marc Zimmerman at the Association headquarters *as soon as possible*. The phone number is 202-293-2971.

If you can help convey the ESOP message to any of these people, we will provide you with the materials to do so.

Again, the House Ways and Means Committee will work on major tax legislation soon. ESOPs are on the table.

New Members

Tim Grumbacher
S. Grumbacher & Son
York, PA

George H. Smith
George H. Smith Co.
Birmingham, AL

M. S. [illegible]
Craig Supply Co.
Durham, NH

Ernest Austin
The Dunlap Agency
Auburn, ME

Dicke Messinger
Power Curbers
Salisbury, NC

Robert Goerlick
Benefit Concepts, Inc.
Diamond Bar, CA

C. J. Schacht
Clas Holding Co.
Cedar Falls, IA

Walter F. Gallien
Spaulding Company
Stoughton, MA

Russell Means
Employee Benefit
Management Corp.
Columbus, OH

Gary Costanza
A.M.E. Inc.
Burbank, CA

William Combs
Signode Industries
Glenview, IL

Aldren Kesner
Culver Stairs
Boston, MA

Paul Russell
Vedder Price Kaufman
Chicago, IL

Richard Brookfield
Brookfield Engineering
Labs
Stoughton, MA

Neil Wagoner
Wagoner Marsengh & Co.
New York, NY

[illegible]
John Henry Bonnet Co.
St. Louis, MO

Jerry Vaughan
Phelps Rubber
Cleveland, OH

B. J. Batson
Lewis Chase
Nashville, TN

Alvin Sherman
Development Corp.
of America
Hollywood, FL

John Arak
American Sterilizer
Erie, PA

William Day
Cleveland State University
Cleveland, OH

Alfred L. McDougal
McDougal Littell & Co.
Evanston, IL

Kevin Reilly
Arthur Young & Co.
New York, NY

Roger Levin
MAP Incorporated
Rockville, MD

William Dolan
Capital Analysts
Rockville, MD

Louis Dobb
Seymour Specialty Wire
Seymour, CT

S. W. Llewellyn
The Lane Construction
Co.
Meriden, CT

Kearney Kerr
Scott Fetzer Co.
Westlake, OH

Lawrence Lipton
Corporate Planning
& Valuation
Oakbrook, IL

Phil Hunnerberger
Beaver Pacific Corp.
San Francisco, CA

ESOPs In The News

The President's Commission on Industrial Competitiveness included ESOPs among its recommendations to American management. The Commission said businesses should make broad use of employee incentive mechanisms such as ESOPs and Incentive Stock Options. The Board of Directors of **Lyon Metal Products** gave their approval for an ESOP leveraged buyout for $28 million pending a definitive agreement and termination of a lawsuit filed by salaried employees. **Granite Construction Corp.** (CA), one of the ten largest heavy construction firms in the country, is now a majority employee owned company after the installation of an ESOP which purchased 51% of the company's outstanding shares. Employees of **Avery-Knodel Television,** one of the top ten TV sales representative firms, are acquiring ownership of their company by use of an ESOP leveraged buyout to buy the shares of the firm's three major shareholders. **Pacific Gamble Robinson Co.** (WA) announced plans to buy 40,000 shares of Pacific stock for the company's ESOP. Rockwell Intl. won the bidding bar for **Allen-Bradley Co.** (WI), beating out a proposal for a leveraged ESOP buyout. **Allegheny Beverage Corp.** (MD) cancelled a planned $175 million ESOP leveraged buyout after learning that proposed regulations in the Technical Corrections Act would "effectively prevent" the company from selling its bottling subsidiary to an ESOP. **National Color Laboratories** (NJ) was acquired by NCL Acquisitions Inc. in a leveraged buyout deal in which an ESOP ended up with 64% ownership of the new company. The 63 employees of **Republic Container Co.** (WV) have proposed to buy their plant from parent LTV Corp. for $2 million by use of a leveraged ESOP. **Eastern Airlines** (FL) reported first quarter earnings of $24.3 million, its third profitable quarter in a row. **The Hawaii State Legislature** passed a bill promoting the expanded use of ESOPs.

ESOPs — Growing Stronger

According to figures recently released by the Internal Revenue Service, there were approximately 6,800 ESOP companies in 1984, covering about 10.2 million workers. That figure is up from 6,300 plans in 1983. The number of new plans introduced in 1984 was up 14% from the previous year.

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June 1985

·ESOP·REPORT·

THE EMPLOYEE STOCK OWNERSHIP ASSOCIATION OF AMERICA • 1725 DeSales St. NW Suite 400 Washington, DC 20036 202-293-2971

Tax Reform Analysis

The Administration's tax reform proposal currently being reviewed by Congress includes recommendations that would drastically alter current laws affecting ESOPs. Under the proposal ESOPs would no longer be treated as retirement plans under ERISA. A new section of the tax code would be created for statutory ESOPs as "vehicles to encourage employee ownership." For this purpose the term "statutory ESOP" applies only to leveraged ESOPs.

Non-leveraged ESOPs would be treated as stock bonus plans under a separate section of the tax reform proposal and the proposed legislation would have a significant effect on these plans as well. The following will provide a general outline of the changes recommended by the Treasury Department.

The new rules would apply to an ESOP borrowing money after December 31, 1985. Since the special exception to the prohibited transaction rules for leveraged ESOPs would be repealed, any loans for ESOPs would have to be made directly to the company rather than to the ESOP trust. Companies would still be able to deduct both interest and principal on the loans by virtue of making contributions to the trust equal to the principal payments on the loan. Loans would have to be repaid over a period of not less than five nor more than twelve years. Principal payments on the loan could still be deducted in amounts up to 25% of payroll. As the principal is repaid a proportional number of shares would be allocated to participating employees based on their relative compensation provided that a salary limit of $50,000 per year would apply for this purpose.

Leveraged ESOPs would no longer be treated as qualified retirement plans so vesting schedules would no longer apply. Employees would thus be immediately 100% vested in the shares distributed to their individual accounts. In addition, employees would be granted "direct ownership rights" which would include full voting rights, the right to transfer the securities and, in the case of closely held companies, the right, after three years, to "put" the stock to the employer annually at a designated time. This means that as the principal on an ESOP loan is

(Continued next page ...)

Lobbying Campaign To Focus On Preserving Key ESOP Features

If passed in its current form, the Administration's tax reform proposal would be quite harmful to ESOPs. However, certain aspects of the proposal can be seen in a positive light. The creation of a new section of the tax code for ESOPs is the first official recognition of ESOPs as a means of promoting employee ownership of capital by any administration. And by combining stock bonus plans with leveraged ESOPs, some companies may be able to deduct an even greater percentage of plan contributions than allowed under current law.

Clearly, however, the proposal is unworkable in the present format and significant changes are necessary to protect the interests of both leveraged and non-leveraged ESOPs. Congress will be holding hearings on the tax reform proposal during the coming months and the ESOP Association will be working diligently to make sure that certain principles which have been developed over the past twelve

(Continued next page ...)

***... Tax Reform** (cont.)*

repaid, stock would be released to the employee's account. The employee would then have full voting rights on the stock in his account as well as the right to sell the stock outside of the company. Employees would pay no tax on the stock until it was sold and would pay capital gains on any appreciation once the stock is sold. Unallocated shares would be voted by the trustee, except on major corporate issues. In these cases the vote would be passed through to participants. Closely held companies would also be required to employ an independent fiduciary to value company stock.

The estate tax assumption provision granted in the 1984 Tax Reform Act would be repealed, but the tax free rollover on the sale of stock to an ESOP and the 50% interest exclusion on loans to ESOPs would be retained. The tax deduction for companies that pass through dividends in cash to employees would also be retained, but companies would be required to make an additional payment to employees of an amount equal to the tax savings realized by the deduction. The PAYSOP credit would be allowed to expire as scheduled at the end of 1987.

Non-leveraged ESOPs would be treated as stock bonus plans under the proposed regulations. As such, they would be subject to the same regulations as would profit sharing plans and defined benefit pension plans. Stock bonus plans would clearly *not* qualify for the tax free rollover as under current law, nor would they be able to take advantage of the dividend deduction afforded leveraged ESOPs. Company contributions to the plan would generally be limited to 15% of an individual's pay, and an excise tax would be assessed on early withdrawals from the plan (prior to age 59½). Upon distribution, the fair market value of employer securities would be fully taxable to the employee as ordinary income. In addition, ten year forward averaging on lump sum distributions would be repealed.

***... Lobbying Campaign** (cont.)*

years will continue to be a central part of any ESOP legislation. The challenge to ESOPs is a serious one and at a time when Congress will be giving close scrutiny to the ESOP concept, it is essential that ESOP companies communicate the key ideas that have made ESOPs such an attractive financial tool.

On June 24th the Executive Committee of the ESOP Association adopted the following principles which would have to be included in any ESOP legislation in order to receive the support of the ESOP Association:

1. Capital, in the form of the employer's common stock, must be required to accumulate in a trust, and the trustee should be subject to fiduciary responsibilities. Unless specified in the plan, there should be no required payment or distribution to employees of the employer's common stock other than as provided under current law;
2. Employees should recognize no income on employer securities in the form of stock accumulating under an ESOP. Following distribution of shares to an ESOP participant, any appreciation of the securities over the trustee's basis should be treated as long term capital gain upon any sale of the securities;
3. Employers should be encouraged to make annual contributions to the trust, in cash or employer securities in the form of common stock. This encouragement, in the form of deductions for such contributions, should be at a level at least equal to current law;
4. Allocations of employer securities should primarily be based on employees' relative compensation with reasonable limits on allocations to certain highly-paid and/or major shareholder/employees, such as provided under current law;
5. ESOPs and ESOP transactions should continue to qualify for present exemptions under federal and state securities laws. In addition, ESOPs should be regulated under federal law rather than under the laws of the 50 states;
6. Participants' accounts in the trust should become vested on a graduated basis over a reasonable period of time;
7. The tax laws should continue to provide incentives for the establishment of leveraged and nonleveraged ESOPs. Various laws enacted over the past 12 years by Congress and signed by four Presidents have provided for important incentives for ESOPs;
8. In matters of corporate governance, the law should recognize the significant distinctions between publicly traded corporations and closely held corporations.

The Treasury Department's proposals are based partly on the assumption that ESOPs are not good retirement policy. Practical experience, however, has shown that ESOPs can provide an excellent retirement benefit and often provide benefits that are superior to standard retirement plans. And in addition to providing employees with significant capital estates, ESOPs are an excellent technique of corporate finance. ESOPs in their current form are beginning to provide certifiable evidence of their benefit to both companies and employees, and the ESOP Association will make a strong case for the need to preserve the above principles. But to communicate that message to Congress we need your help.

ESOP PAC

The ESOP Association has now completed the official registrations required to establish a political action committee. The official name will be the ESOP PAC.

Talking Points on ESOPs

by Jeff Gates

Jeff Gates is a member of the Senate Finance Committee's Minority Staff. In this position he is involved directly in the drafting of legislation affecting ESOPs and works closely with Senator Russell Long on issues related to ESOPs.

Many ESOP companies will be speaking with their Congressman as part of the ESOP Association's lobbying effort on the issue of tax reform. These "talking points" are offered as suggested ways of communicating the ESOP concept to Congressional representatives who may be approaching the ESOP issue from differing perspectives. The following is excerpted from remarks given at the recent ESOP Association convention in Washington, DC.

Describing the ESOP concept is a bit like the blind man describing the elephant -- if he touches its bushy tail first, he thinks it's a broom, if he touches the massive leg first, he thinks it's a tree, if the trunk, it's a snake; if the ear, it's a large leaf.

So think a bit about how you might tailor your comments to issues with which the member of Congress is most familiar. Like the blind man, he or she may never have seen or heard of an ESOP. Or their ESOP concept may differ from yours. What follows is a suggested reason for promoting ESOPs from 15 different perspectives. If your Congressman is concerned with

1. PRODUCTIVITY

Mention that numerous studies are bringing some social science documentation to what common sense suggests, namely that companies with employee ownership are generally more productive, more profitable and pay more taxes than those without.

*New York Stock Exchange - "People and Productivity" study;

*McKinsey Co. (for American Business Conference) - "The Winning Performance of Mid-Sized Growth Companies";

*Atlanta Federal Reserve Study of the 22 premier companies in the south - employee ownership a common thread;

**The Search For Excellence* - Employee ownership a common characteristic. Likewise endorsed in the sequel *A Passion for Excellence*."

2. COMPETITIVENESS

Mention Paul Volcker and his belief that employee stock ownership is a way to make us more competitive in international trade by providing a way for employees to share in prosperity without building in a floor on costs and share in adversity without layoffs. He also wonders why companies aren't including employees more in their planning options and on boards of directors. The President's Commission on Industrial Competitiveness includes ESOPs among its recommendations to American management.

3. RETIREMENT POLICY

(The Ways and Means Committee has a task force on the topic), talk about an anticipatory national capital accumulation policy to relieve some of the fiscal pressures of retirement income security programs (like social security) and policies (like tax incentives for pension plans). Or mention that in 1976 the Joint Economic Committee recommended expanded capital ownership as a national economic policy.

4. FOREIGN RELATIONS

You might mention the use of ESOPs as a model for other nations - and tell him that both the Senate Foreign Relations Committee and a House Foreign Affairs subcommittee recently approved legislation directing the President to examine the use of ESOPs in development policy and to make a report with specific recommendations for action. Tell him the Senate Foreign Aid Authorization bill passed May 15 included that provision.

5. HIGH TECHNOLOGY

Mention how employees are more receptive to labor-saving, job-eliminating technology if they own a piece of it.

6. MERGERS, ACQUISITIONS, HOSTILE TAKEOVERS

(An issue under study by both the Ways and Means and the Finance Committee), mention that employees are the most logical group to benefit from the enormous amount of debt that these companies must repay.

At his confirmation hearing before the Senate Finance Committee, Treasury Secretary Regan explained how Merrill Lynch and Company used an ESOP to divest itself of the Lionel Edie company. Rather than sell the company to someone else, the former Chief Executive explained: "We used an employee stock ownership plan, letting them buy it, and they have prospered as a result of that. I am definitely in favor of that."

7. FUTURE TRENDS

Mention that best-selling *Megatrends* author John Naisbitt has a new book in the works in which he insists that the old definition of compensation is out of date and in prototypical new companies, all employees have some ownership.

8. BIPARTISAN SOLUTIONS

Show him the May 14, 1985 pro-ESOP syndicated column by former Treasury Secretary Bill Simon. Or tell him that 49 Senators sponsored the last ESOP bill - 35 Democrats and 14 Republicans - including 14 members of the Finance Committee.

Or have him look at the Foreign Aid amendment in the House and challenge him to suggest a more bipartisan marriage than the amendment's sponsors Democrat Michael Barnes and Republican Phil Crane. Or look to the Senate's sponsors Foreign Relations Committee Chairman Richard Lugar along with Paul Laxalt, Chris Dodd and Russell Long.

9. SOCIAL JUSTICE

Mention the U.S. Bishops' pastoral, "Catholic Teaching and the U.S. Economy" which advocates wider ownership and workplace participation. Or the Pope's 1981 encyclical "Human Work" and his advocacy of promoting human dignity by associating labor more closely with the ownership of capital.

10. QUALITY OF WORKING LIFE

Mention the recent book, *The 100 Best Companies in America to Work For*, and how employee ownership gives workers a more direct relationship with the company they work for.

11. MANAGEMENT THEORY

Mention how employee stock ownership can help managers implement their long-range plans without being at the mercy of the day-to-day vagaries of Wall Street's speculators and takeover artists.

Or tell him about the ESOP's potential for moving companies away from what the March issue of *Harvard Business Review* calls the "Control" model and toward the "Commitment" model to help reduce the swollen ranks of mid-level management.

12. LABOR-MANAGEMENT COOPERATION

Show how ESOPs represent a means of providing a common ground for negotiation, giving unions a way to win a victory for their members while providing management a way to meet union demands while maintaining wage costs within reasonable limits.

13. WAGE RATES

Explain the dividend deduction and the second income idea. In July of 1974, Ronald Reagan illustrated this point with the following story:

"Some years ago, a top Ford official was showing the late Walter Reuther through the very automated plant in Cleveland, Ohio, and he said to him jokingly, 'Walter, you'll have a hard time collecting union dues from those machines,' and Walter said, 'You are going to have more trouble trying to sell automobiles to them.'

"Both of them let it stop right there. There was a very logical answer to that, the logical answer was that the owners of the machines could buy automobiles and if you increase the number of owners you increase the number of consumers."

14. PLANT CLOSINGS

Mention how an ESOP combined with more competitive wage rates helped Weirton, West Virginia save jobs, save communities (in three states), and save one of the nation's best quality steel producers.

15. NEW FEDERALISM

Mention that thirteen states, plus New York city, now have ESOP-related legislation on the books.

In essence, make it easy for each member of Congress to think about ESOPs and the ESOP concept. At least initially, try to talk about it in a language that he or she understands.

***ESOP Commentary** will be a regular feature of the **ESOP Report**. The ESOP Association solicits views on any issues relating to ESOPs. Articles should be sent to:*

The ESOP Association
1725 DeSales Street, NW
Suite 400
Washington, DC 20036

How Much is Your ESOP Worth?

The most significant issue by far in the coming debate on tax reform as it affects ESOPs will be the effectiveness of ESOPs in providing significant employee benefits. A major reason for the Treasury Department's proposal is based on the assumption that "relying on ESOPs to provide retirement benefits is poor retirement policy" since "a retirement benefit entirely dependent on a single, often unmarketable asset provides an employee little certainty that adequate retirement security will be provided."

Congress wants to know the same thing. As Congressman J. J. Pickle (D-TX) mentioned in his address at the recent ESOP Association convention, the key issue that Congress will study in evaluating the benefits of ESOPs is "how much money they put into the pockets of employees."

Arguments promoting the advantages of ESOPs as tools for corporate finance and for improving productivity, as significant and important as they are, are not likely to convince legislators concerned about the impact various proposals will have on the federal budget, as well as the impact on individual incomes. The challenge to ESOP companies is to prove to Congress that ESOPs are indeed an excellent means of transfering significant amounts of capital to employees.

To get that message to Congress the ESOP Association is focusing its efforts on coordinating face to face meetings between ESOP companies and members of Congress. Of particular importance to our effort is to reach members of the House Ways and Means Committee which will be voting on the initial tax reform bill. The Association has prepared lobbying materials including sample letters, phone scripts and a detailed analysis of the tax reform proposal for presentation to members of Congress. In addition, the Association staff is prepared to travel to the home offices of member companies to assist in meeting with their Congressman. There is no more effective way of lobbying than to have constituents talk directly to members of Congress about issues of concern to them. Because of the seriousness of the threat facing ESOPs, it is essential that every ESOP company take part in this lobbying effort.

Again, the most effective tactic is to have your Congressman visit your company to get a first hand account of how ESOPs work and to talk with employees who are benefiting from the company ESOP. If a visit to the company is not feasible, then try to arrange appointment to visit the Congressman in his or her district office. At the very least, try to talk to the Congressman personally on the telephone.

These efforts should be supported by a letter from a company official detailing the benefits that your company's ESOP provides. Such a letter should include 1) how long your ESOP has been in place, 2) the total value of the benefits that your employees realize through their ESOP; 3) the average benefit per employee; 4) the average percentage of pay your company has contributed to the ESOP each year, 5) comparisons (if any) with other employee benefit plans such as profit sharing and pension plans; and 6) an indication of how you feel that the ESOP has helped increase the value of your company.

Finally, get your employees to write letters to Congress.

The best time to reach your Congressman is when he is visiting the district. The next few months will be critical to our efforts so try to reach your Congressman during the following dates when Congress will be in recess:

June 29 - July 8,
August 3 - September 4,
October 12 - 16.

Please coordinate your efforts with the Association office. Together we can work to protect our common interests.

Federal Reserve Approves S&L, Broker Loans To ESOPs

Savings and loan associations, and securities brokers and dealers may now lend to employee stock ownership plans under changes to Regulations G and T adopted by the Federal Reserve Board on June 19.

Under the changes, S&Ls and securities dealers and brokers will be allowed to lend on a good-faith basis to trusts for ESOPs. This means that S&Ls will be allowed to lend to up 100% of the collateral stock's value.

Though the Fed had never formally proposed the changes to Regulation T which covers brokers, favorable comments and the interest shown convinced the Board to allow brokers and dealers to lend to ESOPs free of the margin limits, but decided to put the formal language out for comment. Comments are due July 22, the same date that the amended Regs G and T take effect.

The effect of the Regulation G changes is to give S&Ls parity with banks in lending to ESOPs. The trustee of a company's ESOP may now borrow from an S&L to buy company stock for the plan's employees. The purchased stock is put up as collateral for the loan.

Both Regs G and T had limited lending backed by securities to 50% of the value of those securities. Such margin limits have effectively precluded S&Ls from lending to ESOPs.

Washington Report

by Michael Keeling

This newsletter devotes considerable space to the challenge of ESOPs embodied in the Administration's tax reform proposal. The Executive Committee of the Association has spent many hours analyzing the proposal. In this effort, they have benefited from the concise observations of leading ESOP practitioners.

Many people ask me if the Association's activities are necessary, and if so, when are they necessary. In other words, will Congress pass the Administration's tax reform proposal? There are plenty of experts who predict that the proposal will never pass.

In my opnion, the question is somewhat academic *because* the House Ways and Means Committee *definitely* intends to work on, and pass to the full House, a major tax reform bill. And the House Committee intends to begin its work shortly after Labor Day of this year.

The evidence of this Committee intent is twofold.

One, the statements of the Chairman of the Committee, Dan Rostenkowski, are sincere, and he usually gets what he wants from the Ways and Means Committee, and

Two, in visits on the Hill, people involved with the legislative process predict this House action will occur.

There is only one meaningful cloud on the horizon for the Ways and Means Committee's plans to pass a tax reform bill. This cloud is the fact that the Administration's proposal may be a revenue loser. A revenue loser is a bill which lowers Federal revenues, and thus exascerbates the already dangerous deficits. If the Administration's proposal cannot be made revenue neutral, then all bets are off on passing a bill.

The revenue problem is so serious that there are rumors in the Senate of a *new* tax levy to make the Administration's proposal revenue neutral.

In sum, the bottom line is this. The House tax-writing committee intends to vote on legislation very soon, and that legislation will contain provisions affecting ESOPs. In order to influence this House action, work by ESOP companies has to occur *now*.

Correction

The May *ESOP Report* incorrectly stated that the dues increase for membership in the ESOP Association would take effect on July 1, 1986. The increase, the first ever for the ESOP Association, takes effect on July 1, 1985.

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STATEMENT BY ROBERT B. GILL, VICE CHAIRMAN, J.C. PENNEY CO., NEW YORK, NY

Mr. GILL. Good morning.

My name is Robert Gill, and I am vice chairman of the J.C. Penney Co. On behalf of the Penney Co. and its employees, I would like to thank Chairman Packwood and the members of the committee for giving us an opportunity to express our views on this very important subject.

Penney, as most of you know, is a general merchandise retailer with stores and catalog operations throughout the United States. Retailing is a highly labor-intensive industry. People are our primary resource. Therefore, we are concerned with the impact of tax reform on employee benefits.

At Penney we have approximately 180,000 employees. We are very proud of our employee benefit package. Our retirement program includes a pension plan, and a savings and profit-sharing plan. We also offer our employees medical and dental coverage, short-term and long-term disability coverage, life insurance, and a discount program for merchandise.

The basic thrust of my remarks this morning is to suggest to the committee that the employee benefit and retirement components contained in the President's tax reform proposal address matters that potentially affect the livelihood and well-being of millions of individual American workers and their families. They deserve the very careful study and attention of Congress and the administration, after hearing the views of all interested segments of our society.

Under the circumstances, we feel it is critical for this committee to consider whether, in the broad context of tax reform, these very complex issues can be dealt with in the time available. ERISA, which in many respects was no less complex than some of these issues, occupied Congress' time for several years. The result of this legislation will be disincentives to individuals and their companies to plan for their own welfare and retirement. The current debate on tax reform may not be the best forum for these important benefit matters to be addressed.

Let me give you some examples that deal with the President's Proposals which, after months of hard work and good-faith efforts on the part of the drafters of these proposals, have nevertheless created as many problems as they have solved.

The proposals would adopt a uniform nondiscrimination test in place of the various rules which now govern welfare and qualified retirement plans. This test would have a very serious and I believe unintended result for our benefit programs. I believe that the employee benefit plans sponsored by J.C. Penney are among the most widely available and least discriminatory in America. Our welfare plans are open to all of our employees who work 20 hours a week for 13 weeks. Our medical plan covers approximately 100,000 employees and their dependents, providing medical coverage to in excess of 250,000 individuals. Benefit coverage is identical for all employees, regardless of their compensation level, and the company pays 75 percent of the plan's cost. In summary, our plan offers nondiscriminatory coverage, is reasonably priced, has a low threshhold of eligibility, and covers significant numbers of employees other than highly compensated. Despite this, the proposed uniform nondiscrimination test would deem our medical and dental plans discriminatory. We understand that the plans sponsored by virtually all other large retailers would be similarly affected. Such results prove to us that this test just does not work.

The President's tax proposal's indicate that adoption of the proposed uniform nondiscrimination test would have a nonsignificant revenue impact. The test goes beyond tax reform, and is in our opinion an attempt to extend Federal regulation.

The Penney Co. has offered its savings and profit-sharing plan since 1939, to encourage employees to save for retirement. Over the years many thousands of our employees have accumulated significant benefits under this plan. We introduced the 401(k) in 1982. As a direct result of that addition, participation substantially increased. Our enrollment increased by 15 percent to 80,000 employees, and the average savings went up to over 1.5 percent of pay.

The proposed treatment of CODA's, in our opinion, will negatively affect participation in these plans. The new dollar cap on contributions, the new IRA offset, and the harsh discrimination tests, will reduce the effectiveness of 401(k)'s as a savings vehicle for future retirement.

The application of these rules would also have a negative effect on employees earning more than $25,000 a year who, in our company, fall into the top 10 percent of our workforce. As applied to J.C. Penney, these employees would be considered "highly compensated" and therefore severely restricted in their ability to save. In our company the top 10 percent of the discrimination rule would fall into the 10 percent area.

Senator Packwood, we are concerned that these matters do require time and attention of Congress. We have outlined these concerns in our statement which has been submitted for the record.

The CHAIRMAN. Thank you.

Mr. Stone.

[Mr. Gill's written testimony follows:]

STATEMENT FOR THE RECORD
BY
ROBERT B. GILL
VICE-CHAIRMAN OF THE BOARD
J. C. PENNEY COMPANY, INC.
BEFORE THE
SENATE FINANCE COMMITTEE
JULY 19, 1985

On June 13th William R. Howell, Chairman of the Board of the J. C. Penney Company filed with the Committee a statement expressing general support for the President's Proposals to restructure the tax Code. In that statement, Mr. Howell also expressed our reservations about certain of the employee benefit and retirement components of the Proposals. I am pleased to have the opportunity to provide a more detailed analysis focusing on these areas.

We believe that four critical elements must set the standard for any tax reform proposal. They are:

(1) a substantial reduction in the maximum corporate tax rate and retention of graduated rates for smaller companies;

(2) an adequate deduction for a portion of dividends paid;

(3) a significant reduction in individual tax rates, increasing consumers' disposable income and ability to save and invest; and

(4) sufficient recognition of the importance of private sector responses to retirement security, health, and insurance needs of our employees.

Consistent with the inclusion of these critical elements, we have pledged our support for the tax reform effort.

The President's Proposals meet the standard set by the first three elements. We applaud the Administration for its attention to these issues and urge the Congress to enact these provisions. Analysis of the proposals relating to employee benefit and retirement plans, however, gives us considerable concern about the fourth element of our criteria for support. As written, we think these provisions do not constitute good tax reform and are harmful to employees. Accordingly, we suggest that these areas be disassociated from the overall individual and business tax reform provisions and addressed separately. The complexity and potential far-reaching impact of these provisions requires that they be given careful study and the undivided attention of Congress to ensure that the proposed changes harmonize with national policy goals for employee pension and welfare benefit plans. We are aware and supportive of the need to keep tax reform revenue neutral. No tax reform measure should be enacted which substantially increases deficits. We believe, however, that modifications are necessary in certain of the employee benefit areas and that those modifications need not seriously damage revenue neutrality.

J. C. Penney has for many years sponsored retirement security and other benefit programs which cover large numbers of hourly and salaried workers. Profit-sharing retirement plans have been a Penney tradition since 1939. We have also had a pension program since 1966 to supplement retirement income from profit-sharing and Social Security. Our medical, dental and other welfare plans provide extensive coverage for our employees and their dependents. We take great pride in the partnership we have established with our employees to insure their welfare and retirement security. In retailing, our people are our greatest resource. Proposals which adversely impact our people or our benefit plans are of great concern to us.

Specifically, the areas of concern to J. C. Penney are as follows:

ESTABLISHMENT OF UNIFORM NONDISCRIMINATION RULES

A variety of discrimination rules currently apply to welfare plans. The Internal Revenue Service has difficulty enforcing these rules, given the almost infinite variety of "facts and circumstances" different taxpayers present.

This Proposal would impose a new uniform numerical test to measure whether welfare plans are discriminatory in coverage and benefits. The coverage test would require that the percentage of highly compensated participants benefiting under a welfare plan not exceed 125% of the percentage of other plan participants. This Proposal would also permit the IRS, in certain circumstances, to rule that this uniform test may be exceeded. Additionally, discrimination would exist if any highly compensated employee had a shorter eligibility period than any other employee. If a plan failed the nondiscrimination test, the income tax exclusion for the value of the coverage (generally employer contributions) would not apply to the highly compensated participants in the plan.

The employee benefit plans sponsored by J. C. Penney are among the most widely available and least discriminatory in America. Our welfare plans are open to all our employees who work 20 or more hours per week for 13 weeks. Our medical plan, for example, covers approximately 100,000 employees and with dependents provides medical benefits to in excess of 250,000 individuals. Benefit coverage is identical for all employees, regardless of their compensation level and the Company pays approximately 75% of the plan's cost. In summary, our plan offers nondiscriminatory coverage, is reasonably priced, has a low threshold for eligibility, and covers significant numbers of employees other than highly compensated.

Despite this, the proposed new uniform nondiscrimination test would deem our medical plan discriminatory. Furthermore, under the proposed test, our dental plan and several of our other welfare plans would be considered discriminatory. It is our understanding that the welfare plans sponsored by virtually all other large retailers, as well as other labor intensive companies, would also be deemed discriminatory. Such results prove to us that this test just does not work. We are uncertain what category of employers or plans were the target of this test, but we find it hard to believe that it was directed at plans maintained by the retail industry.

For many years, our Medical and Dental Plans have been based upon cost-sharing because we believe this encourages participants to be responsible, cost conscious health care consumers. The new coverage test could compel us to lower or waive employee contributions to increase enrollment in order to pass the coverage test. Imposing such a result appears unwise from a health care cost containment viewpoint since it is universally recognized that lack of meaningful cost-sharing for health care coverage leads to over-consumption by users and over-treatment by service providers.

Rather than relying on the IRS ruling process, with all the uncertainty and delays that would entail, we suggest a more realistic safe harbor test for employers with large numbers of employees. The rule could be as follows: A plan would be deemed nondiscrimatory if:

- it covers a large number of employees (e.g. 1,000,5000 or 10,000);

- it contains an eligibility threshold of at least 25 hours per week, and;

- employee contributions and benefit levels are identical regardless of level of compensation.

This safe harbor proposal would have little, if any, revenue impact.

CODA REVISIONS

The President's Proposal would make numerous revisions to Code Section 401(k) cash or deferred arrangements (CODA's). Our analysis of the cumulative impact of these changes should they be enacted in their present form makes us question the continued viability of our Savings and Profit-Sharing Plan. We view this plan as an important component in our efforts to ensure the retirement security of our employees and are, therefore, sensitive to proposals which we believe will jeopardize this plan.

Currently, a CODA is qualified if it satisfies statutory requirements including a limit on employee elective contributions (including those made through salary reduction). This is accomplished by use of an "actual deferral percentage test" ("ADP Test"). The current ADP test applicable to the Penney Company requires that the ADP for our "highly compensated" employees be not more than 250 percent of the ADP for all other eligible employees and not more than 3 percentage points greater than the ADP for all other eligible employees. The ADP for a group of employees for a year is the average of the separate deferral ratios for each eligible employee in the group. An employee's deferral ratio for a year is the ratio of the employee's elective contributions for the year to the employee's compensation for such year. For purposes of the ADP test, "highly compensated" employees are those employees who are more highly compensated than two-thirds of all employees eligible to make elective contributions under the CODA. Employer matching contributions are neither restricted nor counted under the ADP test.

This proposal would alter the ADP test in a number of ways:

(1) The "highly compensated" employee group would be redefined and narrowed. As applied to JCPenney, this group would consist of the top 10 percent of employees by compensation. In addition, the "highly compensated" group would include any employee (including former employees and retirees) who during the three previous years were highly compensated as well as family members of an employee employed by the Company.

(2) The allowable spread in the average ADP between the highly compensated and other employees would be narrowed and the limitation on elective contributions for the highly compensated group, rather than being on an average basis, would be tested on an individual basis. Accordingly, the ADP test, as applied to Penney, would only be satisfied if no member of the highly compensated group had an ADP greater than one percentage point above the average ADP for other employees.

(3) The Company's matching contributions would be added to employees elective contributions for purposes of the ADP test. This would effectively limit the amount of Company matching contributions for the highly compensated. If matching contributions were made on a fully-vested basis

and subject to the proposed CODA distribution rules, the overall allowable differential between the groups would be increased, but only by approximately one percentage point.

The application of the proposed CODA rules is particularly harsh on labor intensive industries with many comparatively low paid workers (e.g., retailing). As applied to Penney, employees earning as little as $25,000 annually would be considered "highly compensated" and have their elective contribution and employer matching contributions severely limited. Workers earning the same amount in another industry would not be considered "highly compensated" and would therefore be allowed to save much more and receive a larger share of employer matching contributions.

Under these restrictive rules, the average savings for the highly compensated group could be lower than the average savings for all other employees. Also, the proposed rules are not flexible enough to take into account differing abilities and inclinations of employees to save at various stages of their careers. For example, young workers with family obligations may be unable to save for retirement at a time when they are legally allowed to save up to 15% of their pay. Later, when they are financially able to save and fast approaching retirement, they may find themselves deemed "highly compensated" and their ability to save legally restricted.

The proposed rules would have further drastic impact on retirement savings plans, like Penney's, which allow CODA (tax deferred) and non-CODA (after tax) employee contributions, both of which are matched by Company contributions on an identical basis. For ADP test purposes, non-CODA savers must be treated as not saving at all, thus unfairly lowering the average ADP for employees other than the highly compensated. This unfair result is a direct consequence of the fact that CODA plans are singled out for contribution limitation purposes.

In the interest of fairness and flexibility we suggest the proposed rules be adjusted as follows:

- Permit the ADP test to be applied on an average basis for both groups as under current law (i.e., average ADP for highly compensated to average ADP of other employees).

- Retain the present law applicable to qualified defined contribution plans with respect to employer matching contributions. Employer matching contributions should not be limited provided that mandatory employee contribution requirements are reasonable and matched on the same basis for all employees. In short, employer matching contributions should not be regulated by the ADP test.

- Establish a minimum elective contribution amount (i.e., a floor) which would permit all employees to contribute up to the designated amount irrespective of the outcome of the ADP test. We recommend for this purpose a minimum amount of $2,000 per year, the same as the IRA limit. Decouple the proposed ceiling on allowable elective contributions from IRA contributions and index the minimum and maximum amounts for inflation.

- For administrative ease, allow large employers to determine the highly compensated group by ignoring family members working for the same employer and those considered highly compensated in previous years.

These adjustments to the proposed rules would permit middle-income workers ($25,000 to $50,000) to save adequately for their retirement and provide the necessary flexibility for all workers to save differing amounts at various stages in their careers as their circumstances permit.

REPEAL OF 10 YEAR SPECIAL AVERAGING

Lump-sum distributions from qualified profit-sharing, stock bonus, pension and annuity plans are currently entitled to favorable tax treatment. Ten year special averaging is a method which taxes lump-sum distributions in the year of distribution as though received ratably over ten years and without regard to the recipient's other income. In addition, if an employee actively participated in the plan prior to January 1, 1974, a pro-rata portion of the distribution is eligible for long-term capital gain treatment in lieu of 10 year special averaging.

This proposal would repeal the favorable treatment accorded lump-sum distributions and subject all distributions from qualified plans to ordinary income tax at the recipient's marginal effective rate. The reason for this change is to foster the concept of uniform tax treatment among qualified retirement plans.

This proposal is unfair because it would fall most heavily on those least able to afford it, namely, long service middle-income employees who have struggled to save and plan for their retirement years. Taxes for those retirees could increase by over 100%.

The gradual phase-out of the current tax treatment is of no help to employees who retire after 1990. Many of these employees have saved for their retirement in reliance on the favorable tax treatment that has been available for many years.

We believe the 10 year special averaging and long-term capital gain provisions of existing law should be retained for lump-sum distributions on account of an employee's death, disability, or attainment of age 59-1/2. This recommendation would repeal the existing law provision which affords such favorable tax treatment for changes of employment prior to retirement.

As an alternative, we recommend that the current 10 year special averaging and long-term capital gain rules be grandfathered for active participants in qualified plans through December 31, 1985. Under this recommendation, an employee's accumulated distribution would be allocable to three potential periods of plan participation: (i) prior to 1/1/74 (eligible for long-term capital gain or 10 year special averaging), (ii) subsequent to 12/31/73 but prior to 1/1/86 (eligible for 10 year special averaging), and (iii) subsequent to 12/31/85 to be taxed as ordinary income.

DISTRIBUTIONS FROM TAX-FAVORED RETIREMENT PLANS

While the previously stated employee benefit and retirement provisions of the President's Proposal create the most difficulty for us, we also believe that worthy of the Committee's consideration is the potential impact of proposed rules for distributions from tax-favored retirement plans.

Currently, distributions are permitted from employer-sponsored tax-favored retirement plans without any special adverse tax consequences upon an employee's separation from service, attainment of age 59-1/2, death or disability. In-service distributions are generally permitted, except for elective contributions to a CODA, which can only be withdrawn on account of hardship.

Under the Proposal, the existing distribution rules would be severely restricted. The reason for this proposed change is to allegedly achieve uniformity in the distribution rules for different types of plans and to encourage retention of amounts in tax-favored retirement plans until retirement.

To achieve these goals, a 20% excise tax would be imposed on early distributions (e.g., distributions occurring prior to age 59-1/2, death, or disability). This tax could only be avoided by rolling over such a distribution to another qualified employer plan or to an IRA. The 20% tax would be lowered to 10% when the early distribution was used to pay for a dependent's college education, the purchase of a first principal residence, or to replace unemployment benefits. Hardship distributions from CODAs would no longer be permitted for any reason. Also, non-hardship distributions from CODAs would no longer be permitted on account of attaining age 59-1/2.

While the goals of uniformity and retention of savings until retirement years have merit, we believe there are inherent inequities in the proposed rules.

The new distribution restrictions would create severe problems for qualified retirement plan loan programs, particularly loans from CODAs. Such loans, by law, must be adequately secured. This requirement has traditionally been satisfied by using the borrower's vested account balance in the plan as security. To the extent an employee's account balance contains elective contributions, such balance would not be effective as security against an in-service default, due to the proposed elimination of hardship withdrawals.

Account balances composed of non-elective employee contributions or employer matching contributions would still be "available" for such security requirements, but access to those account balances to cure a default could trigger the 20/10% excise tax. Moreover, the constructive distributon of such amounts in the event of a loan default would be considered taxable, due to the change in the basis recovery rules. The effect of the new rules would therefore fall hardest on employees who could afford it the least -- those unable to keep up their loan payments because their hours or earnings are reduced, and who thereby suffer an in-service default.

Accordingly, we recommend, in the context of a loan default (i) making the 20/10% excise tax inapplicable to distributions required to satisfy an in-service loan default, (ii) retaining the existing basis recovery rules for constructive distributions made in satisfaction of a default, and (iii) permitting hardship withdrawals of elective contibutions pledged as security to repay defaulted loan amounts.

CONCLUSION

The more we study and analyze those chapters in the President's Porposals directed at employee benefits, the more convinced we become that these areas should be disassociated from overall individual and business tax reform and addressed separately. Fairness and uniformity are aims which certainly are desirable and which we heartily support. However, issues in the area of employee benefits are complex and the potential impact of the proposed changes is far-reaching. If enacted as proposed, the retirement savings provisions would be viewed by many workers approaching retirement as a breach of faith. They will send a clear message to many younger workers that they cannot plan for retirement with any degree of assurance that the rules will not be changed upon them. In addition, the uniform nondiscrimination rules proposed simply do not work and seriously damage some of the most effective welfare plans currently in existence. These issues must be fully analyzed. We are not convinced this can be done in the context of a comprehensive individual and business tax reform package.

STATEMENT OF ROBERT S. STONE, SENIOR CORPORATE COUNSEL, IBM CORP., ARMONK, NY, AND CHAIRMAN, ERISA INDUSTRY COMMITTEE

Mr. STONE. Thank you, Mr. Chairman, Senator Long.

It is my pleasure and responsibility to testify before you this morning on behalf of the ERISA Industry Committee. ERIC, as it is often known by the acronym, represents a broad cross-section of America's major plan sponsors, including, I am pleased to say, General Mills, Aetna, and J.C. Penney, who all appeared here today. And I think it is important to point out that our members generally represent plans with 25,000 or more employees, up to plans much larger such as GM's and IBM's.

There is a vast array of different types of employee pension, profit sharing, and savings plans within our universe, and my remarks today are intended to reflect on the effect on those plans—pension, profit sharing, and savings—from the proposed administration, Treasury tax reform proposals.

The broad spectrum of plans in our universe did not develop in a topsy-turvy fashion. Different plans were developed to serve different employees, different geographic, and different industry needs. ERIC members are dedicated to maintaining and supporting the system which provides flexibility and encourages the formation of plans, and plans that deliver benefits which are appropriate to each individual employment relationship.

Now, let me note that the reactions among ERIC members to the President's proposal differe tremendously. There are some members of ERIC who are big supporters, some who have voiced constructive criticism. Not withstanding the overall approach among our 120 or so members, they are generally united in opposition to proposed changes in the areas of pensions, profit sharings, and savings.

We would point out that the goals of the President's proposals are fairness, economic growth, and simplicity. And in ERIC's view, the proposals may not be fair; they may tend to retard economic growth by discouraging savings; and they would clearly create levels of complexity beyond anything we deal with today.

I think there has been unanimity in criticism of the proposed effect of the new antidiscrimination rules. rather than repeat what has been eloquently said by Dallas Salisbury earlier, I would just point out that in major plans, as well as in the small plans to which he is referring, it would be possible to have 100 percent of a company's employees covered under the plan and still fail the new antidiscrimination provisions. And so it is important to keep in mind that while I honestly don't believe anybody intended that result, that is what we have to deal with, and there must be some recognition of that concern.

But before we go through yet another series of proposed legislative changes, we would submit that the committee should reflect on where we are in employee benefits with regard to pensions, profit sharing, and savings plans.

We have seen a continuing stream of legislation, starting with ERISA in 1974. We had Tax Acts in 1975, 1976, and 1978. We had ERTA in 1981, TEFRA in 1982, the Social Security Amendment

Act of 1983, the Retirement equity Act of 1984, and now we are faced with the proposals. And as the Treasury Secretary has said, he has got some of the proposals on a word processor; it has gotten to the point where all of our major plan sponsors have all their plans on word processors. [Laughter.]

Notwithstanding this—notwithstanding this complexity—it is important to reflect that based on latest Government figures, 56 percent of all nonfarm workers had pension plan coverage, and that larger companies such as ERIC members have all workers covered, and three-quarters of those—to reflect, again, Mr. Salisbury's statistics—three-quarters of those people covered earn less that $25,000 a year.

Given the status quo, the healthy and successful attributes of where we have come in a relatively short time, ERIC wishes to suggest that any changes in the system toward the worthy goals of achieving greater coverage and improving adequacy of benefits delivery are valid and should be considered carefully by the Senate, by the administration, by the House of Representatives; but we would very much like to see it done in a different setting and not where we have to trade benefits off that have been in place for many years in order to achieve revenue neutrality.

Thank you very much.

The CHAIRMAN. Thank you.

[Mr. Stone's written testimony follows:]

WRITTEN STATEMENT OF
ROBERT S. STONE, ESQ.
CHAIRMAN, THE ERISA INDUSTRY COMMITTEE

PREPARED FOR
THE COMMITTEE ON FINANCE
UNITED STATES SENATE
HEARINGS ON THE IMPACT OF TAX REFORM ON
EMPLOYEE BENEFITS AND COMPENSATION
FRIDAY, JULY 19, 1985

INTRODUCTION

I am Robert S. Stone, Senior Corporate Counsel for IBM Corporation. I also serve as Chairman of The ERISA Industry Committee, on whose behalf I appear before you today.

The ERISA Industry Committee, sometimes referred to as ERIC, represents the employee benefit plans of the nation's major private sector employers. As sponsors of plans benefiting over 9 million workers and retirees, we share with this Committee a vital interest in the appropriate tax treatment of pensions, savings plans and other benefits which provide economic security to American workers and their families.

I will today concentrate my remarks on changes affecting employee pension, profit sharing and savings plans, although we also share with others who are appearing before you concerns about proposed changes in the treatment of other forms of employee benefits.

BACKGROUND

Before we examine the impact of current tax reform proposals on penison, profit sharing and savings plans, a general understanding of current programs is necessary.

First, who is covered by tax qualified plans? In 1983, 56% of the 88 million nonfarm workers had a pension plan. That is over 49 million workers and their families. 70% of workers under age 65 and meeting ERISA participation standards were covered. 82% of employees in larger firms were covered. More than three quarters of workers with pension coverage earned less than $25,000 in 1983. These same workers held over 70% of all vested benefits. Clearly, tax reform proposals which affect qualified pension and savings plans have a major impact on the lives, security and well being of middle income families.

Of all those workers **not** covered, nearly two-thirds were under the legal participation age, worked less than 1000 hours a year, had less than a year on the job, or were self-employed. Others apparently are concentrated in small firms who cannot afford qualified plans and who likely are not affected by a tax-incentive system since they have little or no taxable income.

Current coverage, therefore, is broad, covers the majority of those targeted for coverage under current law, and, given the concentration of coverage among those making less than $25,000, can in no way be construed as an extravagance benefiting the wealthy. The current broad coverage under a totally voluntary private pension system is a post-World War II phenomenon which is a testament to the support of the current system by previous Administrations and Congresses.

Second, who actually receives or can expect to receive benefits from the current system? Although the pension system is only now beginning to mature, about 30% of all elderly now receive pension benefits. Those benefits account for 15% of the total income of those over age 65 -- and 45% of the income of those who do receive pensions. Among those **now** retiring, 56% of couples and 42% of unmarried persons receive pension income. 75% of younger couples and 65% of singles can expect to receive a pension benefit when they retire in the future. Calculations of coverage in this area often understate the actual impact of current pension coverage since pension and savings plan distributions not in annuity form often are not included in current tabulations of pension income.

About one third of the workforce has little or no individual savings other than that in their employer sponsored pension and savings plans.

Some may look at these numbers and call the glass partly empty; we see a glass rapidly getting more full. Pension benefits are important to a large sector of the population and the impact of the pension system on American retirement is expected to grow dramatically in the coming years.

Third, why are there so many different plans? The current system offers a variety of plans that meet the needs of various workers and the varying resources of sponsoring employers. In defined benefit plans, a relatively secure employer asumes the risk of investment and provides employees with a pre-established benefit. In defined contribution plans, the employee assumes more of the risk of investment but may gain faster vesting and more individual flexibility. Profit sharing and thrift plans share the burden of saving between the employer and employee but also provide incentives for the employee to save in a disciplined manner, resources to meet individual needs throughout one's life, and a savings pool that will convert to retirement needs at the appropriate time.

Fourth, what is the cost to the government of the current system? The FY 1986 tax expenditure estimate for pension plan contributions and earnings is $55.1 billion. However, taxes are paid on all qualified plan funds at some point since the worker pays taxes on all plan distributions not previously taxed. Even accounting for the possibility that individuals could be in a lower bracket when the tax is paid, workers now entering a pension plan will eventually repay from $0.60 to $0.82 of every $1.00 deferred. This repayment would increase under a system of fewer brackets.

In computing the cost of the current system to the government, policymakers must also calculate the replacement cost if the loss of private sector coverage resulted in demands for increased government protections.

Pension, profit-sharing and qualified savings plans also represent an investment of $1 trillion in the economy -- the largest source of business investment capital and the source of more than one third of all venture capital last year. If pension and savings plans are diminished, the loss of savings and usable capital would reduce economic growth, worker productivity, and eventual taxable income.

Fifth, how important are employer sponsored pension and savings plans to employees? A 1985 survey commissioned by ERIC and APPWP and conducted by the respected public opinion research firm of William R. Hamilton found that 80% of workers believe it is important to have a pension or profit sharing plan where they work. 82% said many employees would fail to provide for their own needs if employers did not provide benefits to employees and that the government would end up paying in some way. A majority of those surveyed opposed taxing employee benefits in order to lower overall income tax rates.

POLICY ARGUMENTS

Some policymakers in the Administration and Congress argue that the current employee benefits system is inequitable, results in a loss of federal revenue, and/or represents an intrusion on individual choices in the free-market. Defenders of the system dispute these arguments and point to the advantages of group benefit protection, wide coverage under the current system, equitable distribution of benefits, and the importance of private/ public sector partnership in meeting the economic needs of American workers, and in encouraging savings.

A summary of the arguments follows:

Self-administered Arrangements v. Group Protection

Those favoring an individual or self-administered approach to benefit protection argue that in a free-market economy, it is better to give individuals the responsibility of making their own arrangements for insurance against unforeseen risks and financing their own pensions, profit-sharing and savings plans for retirement.

On the other hand, access does not equal equity. Even if individual arrangements (such as IRAs) are available to workers, data show that some workers are unable and choose not to participate. Group plans offer greater security, lower costs, more convenience, and a disciplined approach to savings and risk protection. Group plans are professionally designed and administered. Group plans by law must benefit a non-discriminatory group of employees, thus ensuring greater equity.

Horizontal Equity v. Broad Coverage

Some argue that it is unfair that taxpayers with access to certain benefit programs receive a tax preference when other individuals must purchase benefits with after-tax dollars.

On the other hand, most employees with a substantial attachment to the workforce are covered under current employer-provided benefit plans. Penalizing a vast majority of workers for the coverage they enjoy would be less equitable than providing incentives and alternatives for those who do not have coverage.

Tax Simplicity v. Convenience

Some argue that the complicated tax code is a source of frustration to a majority of Americans. Eliminating a range of incentives in the tax code, including those dealing with employee benefits, would make the system simpler.

On the other hand, current proposals do not, in fact, make the tax system simpler for workers. For instance, employees are not currently required to keep track of the value of their employer-provided benefits nor handle the details and paperwork associated with plan administration. If they were required to pay taxes on benefits or shop for their own coverage, they would encounter greater complexity and would need to acquire additional information and expertise to make the right decisions and additional income to purchase higher-priced benefits.

Moreover, proposed changes in the rules governing the administration of benefit plans would make them far more difficult to maintain, adding to the current regulatory burden of employers.

Tax Progressivity v. Equitable Participation

Some argue that tax-favored employee benefits primarily benefit the upper-income and result in unfair tax advantages.

But this argument is not true. Employee benefit plans are definitely not "fringes" or "loopholes" for the wealthy. Current law requires that plans benefit a non-discriminatory group of employees and as a result, three-quarters of those participating in benefit plans earn less than $25,000 per year.

Base Broadening v. Hidden Tax Increase

Critics of private sector benefits argue that non-wage benefits are growing as a percentage of total compensation and the amount of income available for taxation is decreasing. Given large budget deficits, the government cannot allow benefits to escape taxation.

However, less than 10% of an employee's total compensation package --including salary, paid absences from work, employer contributions to government programs (Social Security, unemployment insurance, etc.), and tax-favored employee benefits (pensions, insurance, etc.) -- receives any favorable tax treatment.

In the case of pensions and retirement savings, the employee pays taxes on a deferred basis when the benefit is received. Given the broad coverage of current benefit programs, taxing benefits is simply a tax increase and not "base broadening."

Retirement v. Non-Retirement Savings

The Administration and others argue that tax preferences given to savings in employer-sponsored benefit plans should be used for retirement income only and benefits should be received in a monthly income stream after retirement begins.

Yet, given the low rate of savings in the United States versus other industrialized nations, national policy should encourage all types of savings. An estimated 29 percent of workers have no savings or assets beyond what they accumulate in employer-sponsored retirement, profit-sharing and savings plans. For many individuals, the savings accumulated in these plans will be used for retirement security once the employee approaches retirement age.

In addition, new restrictions or tax penalties for receiving pre-retirement distributions from savings plans will discourage many workers -- especially younger and lower-paid employees -- from participating in company savings plans.

Deficit Reduction v. Replacement Costs

Some argue that large federal budget deficits require additional revenue-raising measures. Employee benefits are a source for these revenues.

However, the only way to generate large sums of revenue from employer-provided benefits is to tax the annual contributions and accruals in pension plans and/or a significant portion of the premiums paid for health and life insurance coverage. Such a tax would have the effect of making these benefits less attractive. Individual employees might collectively "opt out" of the system in exchange for consumption income.

In the future, these same workers would most likely turn to the government for their financial needs -- especially as they neared retirement with insufficient savings for living and medical expenses. The "replacement costs" to taxpayers in the future would more than offset the temporary increase in revenue from taxing benefits today.

Public Sector v. Private Sector Responsibility

Some critics of private sector benefits argue that the nation would be better off with publicly financed national programs for medical expenses and retirement income instead of plans operated by private sector employers.

Yet, our nation has preferred variety and flexibility in protecting individual citizens against the economic consequences of death, injury, illness or poverty in retirement. Benefits have traditionally been viewed like pay -- something to be decided between employer and employee. Dismantling the private sector employee benefits system, for whatever reason, would disrupt a fundamental social covenant between workers, employers and their government.

ADMINISTRATION'S TAX PROPOSAL

The Administration's May 1985 tax reform proposal makes dramatic changes in the Tax Code. Some ERIC companies do not support the overall plan. Other ERIC companies have applauded the plan or support the general effort for tax reform. Whatever our members' individual positions on tax reform, however, ERIC companies have been united in their opposition to provisions that would dramatically alter the operation of basic pension, profit sharing, and/or savings plans, some of which have been in operation for a hundred years. The provisions we are concerned about are estimated to produce relatively insubstantial revenue.

New coverage test for all qualified pension and savings plans (Chapter 14.09 of Administration's Tax Proposal):

Current Law: Under current law, a plan must meet certain percentage coverage requirements or be found by the Commissioner of the Internal Revenue Service not to discriminate in favor of officers, shareholders or highly compensated employees as to benefits or contributions. Any plan must cover a broad cross section of employees in order to be qualified as nondiscriminatory. The test is structured to provide basic guidelines while providing a mechanism for the IRS to deal with specific facts and circumstances.

A. New income distinction among participants:

Proposal: Under the Administration's plan the definition of the highly compensated -- or the "prohibited group" -- would be a mechanical definition that generally would include anyone who either earned at least $50,000 a year, was in the top 10% of payroll for the entire company or who was related to someone in these categories.

Concerns This mechanical prohibited group test will produce problems and unusual circumstances which the Congress will want to review. Specifically, in a company where salary ranges are fairly high, the prohibited group may include a fairly large percentage of the workforce, not just highly compensated employees. In a company where salary ranges are fairly low, the prohibited group will include individuals making $30,000 or less. In fact, it is possible for someone making $21,000 to be in the "prohibited group" under this test.

Companies who have large numbers of rank and file employees who are related to each other have absolutely no means of determining who must be added to the "prohibited group" because they are married to or otherwise related to someone who falls within the bounds of this mechanical test.

Many large companies also would have to aggregate data from separate payroll centers, information which may be impossible to compile for the previous three years, as the proposal would require.

This mechanical definition of a "prohibited group" is not likely to produce a balance between coverage of highly compensated individuals and other employees and is more likely to produce a hodge-podge of results that bear little or no relation to the policy objective of ensuring that rank and file employees are adequately protected.

B. New percentage coverage test:

Proposal: Once the "prohibited group" is established for a company, it is then used to determine whether a plan will be deemed discriminatory in its coverage under a second mechanical test, which, in general, works as follows: The company must calculate the percentage of the prohibited group which is covered under the plan being tested. It must also calculate the percentage of all other employees which are covered under the same plan. The coverage percentage for the prohibited group cannot exceed 125% of the coverage percentage for all other employees in order for the plan to be tax qualified. For example, if 95% of the prohibited group is covered under a plan, then 76% of all other employees must be covered under that plan in order for it to qualify.

Concerns: It would be possible for a company to cover 100% of its employees under qualified pension and savings plans and have several plans fail this coverage test. Indeed, any company, large or small, which has more than one plan for its employees could easily fail this test, or could pass it one year and fail it another as the composition of the workforce changes.

Companies have different plans for different segments of their workforce in order to reflect competitive labor markets, different lines of business, different geographic locations, different worker needs and for similar reasons. This mechanical coverage test does not allow for these differences. The test could distort business decisions, result in the establishment of uniform plans which do not suit any segment of an employer's workforce well.

It would be difficult to overemphasize the harm that would be caused by passage of this mechanical rule. Large numbers of established plans, some of which have been in existence for decades and which collectively cover tens of millions of workers and their families, are finding they would not qualify under this proposed scheme.

Moreover, under this mechanical rule circumstances which under current law might raise questions of discrimination might escape scrutiny entirely .

Finally, if the primary objective of this proposal is to provide ease of administration for the Internal Revenue Service, we would suggest that that goal would be inappropriate and elusive. Millions of employees should not have their benefits jeopardized simply to provide an easier rule for the IRS. In addition, the establishment of such a rule will most likely rapidly lead to "exceptions" for comparable plans, different lines of business, different geograpic locations, and other legitimate employee needs which will prove no less complicated than current law to sort out.

Revenue: This change is estimated to produce no additional revenue for the tax reform plan.

ERIC Position: ERIC strongly urges that this item be removed from the consideration of the tax reform proposals so that a more workable approach can be carefully constructed. ERIC would be pleased to work with this Committee and with Treasury to attempt to find answers to any specific problems that they may wish to address in this area at a later date.

Restrictions on employee profit sharing and savings plans (Chapters 14.02 and 14.04 of Administration's Tax Proposal):

Current Law: Qualified pension plans provide payments to beneficiaries generally upon disability, death or separation from service. In the private sector these benefits generally are employer funded. Profit sharing, thrift and other employee savings plans also provide substantial retirement income to employees and are designed to encourage the employee to put away money over his or her lifetime.

Proposal: Tax favored status would be reserved only for employee savings which is generally restricted to supplying monthly retirement income. This would be accomplished by (1) denying employees access to their own after-tax contributions to a plan until all taxable money had been withdrawn so that any money withdrawn would, first, be subject to income tax; (2) eliminating 10 year averaging, special capital gains treatment and deferral of the unrealized gain on employer securities, which currently help to prevent a worker from being pushed up in the income tax brackets by receipt of a plan distribution; (3) subjecting distributions prior to age 59 1/2 to a 20% excise tax on top of federal and state income tax (with the excise tax reduced to 10% in some instances); and (4) subjecting distributions over $112,500 to an additional 10% excise tax on top of other income and excise taxes.

Concerns: These restrictions represent a major change in national savings policy which has supported profit sharing and thrift plans since the 1920s through the tax code. The restrictions will result in dramatically reduced savings among workers, who will not be able to "lock their money up" for decades. It will be extremely difficult to get younger workers at any income level to participate in company savings plans.

Treasury argues that the excise taxes are not penalties but just "recaptures" of the tax privileges when money is not used strictly for retirement income. However, the excise taxes and other penalties in combination will present both real economic loss and an insurmountable psychological barrier against savings for most workers. These disincentives also ignore the fact that a disciplined savings program and accumulation of savings throughout one's life affects retirement security just as much as a strictly defined retirement income stream.

Concerns have been raised that money distributed to employees before retirement (such as when an employee leaves a company) is spent rather than saved. However, available data shows that while this may be true for small amounts of money, of distributions over $5000 almost 60% is saved; of distributions over $10,000 almost 80% is saved; and of distributions over $20,000, almost 90% is saved.

Moreover, focusing on the fate of money cashed out of plans before retirement ignores the more important question of the money which remains in plans and eventually becomes an important part of a worker's retirement pool. This is a critically important consideration for the millions of workers who do not have, and are not likely to have, substantial savings from any other source.

Revenue: The Administration's proposal shows revenue gains from these changes beginning at $1.2 billion in 1986 and reaching $4.5 billion in 1990, totalling $15.7 billion over the five year period. Most of the revenue gained from the proposed new taxes on qualified plan distributions -- $11.3 of the $15.7 billion -- would come from repeal of the three-year basis recovery rule. This rule affects the timing of taxation on amounts distributed in annuity form from contributory defined benefit plans. These plans are prevalent among state and local governments.

The remaining $4.4 billion revenue would come from individuals who did not -- or most likely could not -- conform to the IRA rollover and payout schedule envisioned by the President's plan. In all likelihood, the persons most heavily hit will be middle and lower income workers who will not be able to avoid the proposed tax increases through the IRA rollover device. the principal impact of these changes is to impose additional taxes on the savings of lower and middle income workers who are unlikely to have significant savings outside their employer plans to meet needs not foreseen in the tax reform plan.

The Administration's plan would expend $4.1 billion over the same five year period in an IRA expansion that, consistent with past experience, will be available only to higher paid individuals who can afford to and are otherwise motivated to divert larger amounts of current income.

ERIC Position: **Few policy choices facing this Committee will have as long-reaching an effect on American workers for as little revenue as would a decision to reverse 70 years of support for employee savings plans.** ERIC strongly urges the Committee to preserve the current tax treatment of these plans, both in terms of providing employee access to funds to meet needs which arise over a lifetime and in terms of providing flexibility in the form of payment of funds from qualified plans.

Lump sum distributions from a qualified plan do not work against the economic security of workers. The current system has been successful in providing the bulk of its accumulations to employees for retiement. It does this in part by giving employees flexibility in meeting other needs, by encouraging savings for many purposes, and by providing a disciplined framework for savings. National policy must be guided by patterns of practical experience and not by isolated exceptions to the rule.

Restrictions on 401(k) plans (Chapter 14.06 of the Administration's Tax Plan):

Current law 401(k) plans are tax qualified profit sharing or stock bonus plans which give an employee the option of receiving cash or of having the employer make a contribution to the plan. If the employee chooses to have the employer make a contribution to the plan, he is not taxed on the contribution until he receives a distribution from the plan. 401(k) plan contributions are covered under the general rules limiting contributions to pension plans (I.R.C. Sec 415) and, in addition, contributions on behalf of the higher paid one third are limited by contibutions made on behalf of the lower paid two thirds. In many plans, elective contributions are matched by the employer.

Proposal: The President's tax proposal limits contributions to 401(k) plans in several different ways, only one of which is a special overall cap. Elective contributions would be limited to $8000 offset by IRA contributions. A new "prohibited group" would include those earning over $50,000, or the top 10% of payroll, and those "related to" these individuals. There would be a new coverage standard similar to the one for qualified plans (see prior discussion) except that it would be limited to employees "eligible" for the plan. There would be a new, stricter average deferral percentage (ADP) test which would be applied on an individual basis. Employer matches would sometimes be included in the calculation of the ADP test. There would be a 10% excise tax on excess contributions. No distributions would be allowed before death, disability or separation from service.

Concerns: The proposed changes severely restrict the viability of 401(k) plans. Distributions not only would be denied for any form of hardship but also would not be available after age 59 1/2 unless the employee quit his or her job. These restrictions on potential access to funds will diminish the attractiveness of 401(k) plans for younger workers. At the same time, the proposed cap on elective contributions and the restrictions placed on contributions through the ADP and other new rules are largely duplicative of each other, adding unnecessary complications to the operation of these plans. 401(k) contributions would have to be tested under the 415 limits (including a new 15% of individual compensation limit), the special cap, the new ADP test, the new matching test, and the IRA offset in order to qualify for favored tax treatment.

Moreover, there is as yet considerable confusion about how the proposed rules in the 401(k) area actually can be expected to work.

Revenue: Approximately $10.2 billion is estimated to be raised from the proposed restrictions on 401(k) plans and the denial of these plans to state and nonprofit organizations.

ERIC Position: If changes in the 401(k) area are believed necessary by the Congress, ERIC strongly urges that the changes be limited and simple. These are viable and important savings vehicles and they should be made useful and encouraged. They are more beneficial than IRAs for middle and lower income individuals. Unlike IRAs they are covered under overall limits on pension plan contributions. They may be particularly well suited for expansion of coverage into areas where coverage is now weak or lacking. They also offer an attractive supplement to other pension coverage without exceeding overall Internal Revenue Code limits. Moreover, tax expenditure numbers do not account for the fact that taxes will be paid on all funds in 401(k) plans at the time the benefits are received by the worker.

Other proposals:

A. Change in 15% of aggregate compensation limit:

Current law: An employer can deduct contributions to profit sharing and stock bonus plans so long as the contributions do not exceed 15% of the aggregate compensation paid to covered employees.

Proposal: The aggregate limite would be replaced by a limit of 15% of an individual's compensation.

Concerns: The individual limit would effectively lower contributions for lower paid employees nearing retirement in plans which have a length of service factor in the contribution formula. This would be especially harmful for employees who already have substantial service in such plans and would unnecessarily preclude flexibility in design of retirement plans.

ERIC position: This provision should be removed from any proposed legislation.

B. New limit on employee contributions:

Current law: The lesser of one half of an employee's own after-tax contributions to a qualified plan or the employee's contributions in excess of 6% of compensation are included in overall limits on contributions to qualified plans.

Proposal: The 6% of compensation "carve-out" would be eliminated.

Concerns: Contributions made on an after tax basis by employees should be encouraged. This proposal imposes an unnecessary restriction and disincentive on such contributions.

ERIC position: This provision should be removed from any proposed legislation.

CONCLUSION

ERIC believes that the proposed changes affecting pension, profit sharing, and employee savings plans should be removed from the tax reform proposals. Future revenue collections or potential rate reduction would not be substantially affected. In those few areas were some change may be required, ERIC believes alternatives can be found which would be less detrimental and less complex than those of the current proposals.

Current national policy supports a system of economic security for most American workers through benefit programs maintained on their behalf by employers. Incentives in the tax code encourage employers to provide pension, profit sharing and savings plans and other benefit programs for the welfare of individual workers and their families.

The policy is successful and has enjoyed support from national Administrations and Congresses throughout this century. A majority of full time workers at all income levels are covered by basic benefit programs. More than three-quarters of those covered by benefit programs make less than $25,000 a year -- benefits are not "fringes" or "loopholes" for the highly-compensated. The benefits system is flexible, diverse and efficient, accommodating differences in industry structure, family structure, labor force and demographics.

Despite its success, the private sector benefits system, beginning with the 1982 and 1984 tax acts (TEFRA and DEFRA) has come under fire. A range of current proposals, including the Administration's May 1985 tax reform package, would impose new and/or higher taxes on savings and benefit programs and new limits and restrictions on those who participate. New taxes and restrictions would hit employees at all income levels in the workforce and discourage savings. Higher taxes on distributions from savings and retirement plans would erode their value to individual employees,and new restrictions would limit the amounts that employrs can set aside on an employee's behalf.

Some policymakers argue that the current private sector benefits system is inequitable, results in loss of federal revenue, or intrudes on individual choices in the free market. Defenders of the system dispute these arguments and point to the advantages of group benefit protection and security, wide coverage under the current voluntary system, equitable distribution of benefits, and the importance of private/public sector partnership in meeting the economic needs of American workers.

The long term impact of proposed changes in the national policy on employee benefits requries careful evaluation. Reducing the attractiveness of currentprograms culd lead workers (especially those who are younger) to drop coverage or reduce savings. In future years, pressure on government to replace benefit programs could result in higher net expenditures by government and an increased burden on future taxpayers. The principal source of investment capital for business (pension, savings and profit sharing funds) could be jeopardized.

ERIC urges this Committee to protect the private sector employee benefits system by removing harmful and unnecessary changes in employee benefit law from tax reform consideration.

The CHAIRMAN. Senator Long?

Senator LONG. Mr. Braun, there are a number of questions that I want to submit for the record in order to save time, and I would appreciate it if you would simply give me your responses when the questions are presented to you.

QUESTIONS FROM SENATOR LONG TO WARREN BRAUN

(1) Does the Association support the free transferability of ESOP stock, as recommended in the President's proposal?

(2) Does the Association support the proposal to allow employees to sell back to the company each year their ESOP stock?

(3) Do your members support the Administration proposal denying companies the ability to have reasonable vesting requirements in ESOPs?

(4) Does the Association support the Administration's proposed changes concerning voting pass through on ESOP stock?

(5) Does the Association support a $50,000 ceiling on an employee's salary for purposes of allocating ESOP stock?

(6) Do your members support the proposed denial of the 1984 ESOP incentives for nonleveraged ESOPs?

(7) Does the Association support the proposal's requirement that only "outstanding" shares be acquired by an ESOP?

(8) Does the Association support the proposed repeal of the 1984 incentive allowing ESOPs in certain instances to pay a shareholder's estate tax in return for employer stock?

ESOP

The
Employee
Stock Ownership
Association

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November 7, 1985

Senator Russell Long
United States Senate
225 Russell Building
Washington, DC 20510

Dear Senator Long:

In response to your letter requesting the views of the ESOP Association on various specifics of the Administration's tax reform proposal, let me assure you of the following:

(1) The Association does not support the free transferability of stock by employees in an ESOP;

(2) The Association does not support the proposal to allow the employees to sell back their stock to the sponsoring company each year;

(3) Our members do not support the repeal of reasonable vesting requirements for ESOPs;

(4) The Association does not support the Administration's proposal for full voting rights pass-through on ESOP stock;

(5) We feel the proposed $50,000 ceiling on an employee's salary for purposes of allocating ESOP stock is much too low;

(6) Our members do not support the proposed denial of the 1984 ESOP incentives for non-leveraged ESOPs;

(7) The Association opposes the proposal requiring that only "outstanding" shares be acquired by an ESOP;

(8) The Association opposes the repeal of the estate tax assumption by an ESOP as granted in 1984.

Since you wrote me requesting the above answers, the House Ways and Means Committee has passed by voice vote an amendment repealing most of these proposals. We are, of course, delighted at this show of support for the ESOP concept by key Congressmen though we are concerned about the sunset of the 1984 ESOP incentives.

As you know from the General Accounting Offices initial results of their study of ESOPs, the concentration of capital ownership in

America is still very great and employee stock ownership has only just begun to address that grievous imbalance. The 1984 ESOP incentives have been instrumental in attracting many new companies to the idea of employee stock ownership and continued incentives are crucial if we are to encourage more companies to take the initial step of sharing ownership with their employees.

The ESOP Association directed an extensive grassroots lobbying campaign to convince the members of the Ways and Means Committee of the need to preserve current ESOP laws. We are proud of our achievement in convincing them of the importance of ESOPs and we look forward to working with you in the future to ensure the continued strength of the ESOP movement.

We also look forward with great anticipation to hosting a testimonial dinner in your honor on the opening night of our 1986 ESOP Association convention. We expect a record-breaking attendance and we intend to do everything possible to make sure you will have an evening well worth remembering.

Finally, you may recall from our conversation at breakfast prior to my testimony before the Finance Committee on July 19 that I intended to transfer even more ownership to the employees of my company, ComSonics, Inc. I am happy to report that ComSonics employees now own 100% of their company. Since 1975, the year we first established our ESOP, ComSonics has grown 1240% and we expect that growth to continue and I can assure you that our employees are realizing significant capital accumulation from their ESOP accounts.

Our employees, and the employees of thousands of other ESOP companies, are proof that employee ownership works well and is helping to broaden the base of capital ownership in our economy. We want to help you make employee stock ownership a reality for all American workers.

Thank you for all your help and I look forward to speaking with you again soon.

Sincerely,

Warren

Warren Braun
President

Senator Long. I want to ask you about this matter that appears in the information in your statement and in what you have said.

It says currently your employees own 48 percent of the stock, and you own the remaining 52 percent. You tell me within a couple of years the employees are going to own 100 percent.

Mr. Braun. That is correct.

Senator Long. You plan to retire after that?

Mr. Braun. No, sir; I don't plan to retire.

Senator Long. You are not planning to retire?

Mr. Braun. I will be minding the store, to make sure that the employees do it well and do it successfully.

Senator Long. How are you going to live? Are you going to get a salary?

Mr. Braun. Yes, sir; that is all I'm going to do. I am going to be there as a salaried employee.

Senator Long. Let me get this straight. [Laughter.]

After building this company from nothing up to a very successful company, it is your plan to turn the thing over to the employees and then go to work for them with you owning no stock in the company?

Mr. Braun. That is correct, sir.

Senator Long. They would own it, and you wouldn't own any?

Mr. Braun. I will own none. That is correct. In fact, that transition will be made within 2 months; the schedule has just recently been accelerated.

Senator Long. Well, if you will just stick around, I will send for a halo. [Laughter.]

Mr. Braun. Now, Senator Long, you have raised the question, and I would like to answer it. I happen to believe that the employees deserve an opportunity for equity participation on a very high level, and I have seen the motivation that goes with that, I have seen the impovement in productivity, I have seen a company grow like I didn't believe could happen. And the growth, as you have seen, is almost meteoric. Now, you are going to hear this same kind of hymn coming from many people who manage ESOP companies. It is very enlightening to see the synergism that occurs when you take the ESOP concept, where people actually own the company, and you combine that with participative management. We can beat the tar out of the Japanese that way, and I don't know of any other way that we can do it.

Senator Long. I have discussed employee stock ownership with the President; but I regret to say, when I went to the White House, I was focusing on the amendments which I managed to achieve through the years that the Treasury plan would have repealed.

Incidentally—I don't want to quote the President, but what he said, in effect, is that he is for ESOP and didn't want to do anything to hurt employees stock ownership. He is for simplification but doesn't want to hurt ESOP's.

Now clearly, those people in Treasury were not doing the President's bidding when they sent up something that would do all the things it would have done. I did know that the part I didn't even bring up had other things in there that would torpedo the ESOP even if you did leave my amendments in place.

Mr. **Braun**. Of course. It is the most speciously worded bill I have ever seen.

Senator **Long**. Well, it looks to me as if it is the greatest example of overkill I have ever seen in my life.

Mr. **Braun**. Yes, sir.

Senator **Long**. So I suppose I have some work left to do I didn't plan on having to do. I thought we had pretty well taken care of that matter down at the White House.

But I think when we testify against this, it is not fair to talk about the President's plan insofar as these proposals that torpedo ESOP's are concerned. The President has no sympathy for doing anything like that, based on having discussed employee stock ownership with him several times, and based on the statements he has been amking for 11 years in this country, long before he became President. I am satisfied that there is not one word of these things that would hurt employee stock ownership that the President has approved.

Mr. **Braun**. Yes, sir.

Senator **Long**. So if they succeed in torpedoing employee stock ownership, I am confident they will be doing it without the support of the President. I don't think he believes in one word of that.

Mr. **Braun**. No, sir; I don't either.

Senator **Long**. Then whoever is responsible for this foolishness, if they want to, I would be glad to provide them a seat in the Senate family gallery. It might require a little time to dispose of their handiwork, and I would be glad to provide them with a seat in that gallery to watch. It might take a month or so, but maybe we could get done in less time than that. [Laughter.]

Mr. **Braun**. Thank you, Senator Long.

Senator **Long**. Thank you.

The **Chairman**. Ms. Walsh, let me ask you a question on nondiscrimination in educational plans. In your statement you indicate that in order to use these plans—and most of them are not a year at harvard; most of them are community colleges, or you go at night and have to do some studying, and it takes some degree of motivation on the part of the employee to do it.

Ms. **Walsh**. That is correct, Senator.

The **Chairman**. If we go to the proposed nondiscrimination rules that the administration has, what do you envision will happen.

Ms. **Walsh**. Oh, I think some of the lower paid employees who do take the community college type courses, the vocational training type courses, won't be able to be counted, because the test is for degree-related only, and I think it would——

The **Chairman**. Which is by far the smaller part of the education.

Ms. **Walsh**. The very smaller part. Our survey does correspond to that, that the biggest chunk are the entry level employees who need to get reskilled, who need to learn because of technological changes, demographic changes in the workforce, competition, et cetera. There are skills that they need, and they take them at the local community college, and it is usually vocational types of courses—computer processing, that kind of thing. And the nondiscrimination tests are designed for degree related only. We are not sure w[illegible] with that; it doesn't really make much sens[illegible]

Th[illegible] perience with these plans—it is the sam[illegible] way the old law used to be. If the empl[illegible] under the old law, and it related to v[illegible] income.

M[illegible]

Th[illegible] vice president of IBM, there was prob[illegible] uld take that wouldn't be counted as rela[illegible] probably go to Geneva for a year, and [illegible] to the job. But if the purpose of the course [illegible] so that you could move from the tool crib to assistant [illegible] and that is a change in a job, then that is income[illegible]

Ms. W[illegible] correct.

The C[illegible] of course, the very people it was designed to help are th[illegible] that dropped out of high school, or the kid that just barely finished high school and is now working and wants a little bit more education, and we used to tax them. So we changed that and said that all employer provided education wasn't taxable. And for the life of me, I have not heard one whit of criticism about it. I am delighted that the administration has changed its position and is now going to say this should not be taxed. But of all the fringe benefits that are designed to tilt toward disadvantaged, lower income employees, this is that benefit.

Ms. WALSH. Oh, yes, we agree.

The CHAIRMAN. Well, I am glad you agree. I don't know why I thought you wouldn't. [Laughter.]

I have no other questions. Senator, do you have any more?

Senator LONG. Yes, I do. I just want to mention one or two matters with Mr. Braun.

Mr. Braun, if this Treasury recommendation against which you are testifying gets in the law, that requires very early vesting in the employees, and where any time he wanted to do so, would you set up an ESOP plan in your company?

Mr. BRAUN. No, sir. Nor would anyone else. I would destroy the existing programs, and there won't be any more in the future.

Senator LONG. Would you mind explaining why you wouldn't do it?

Mr. BRAUN. Certainly. The necessity to have a vesting program and an accumulation period is essential to the training period that is required to develop the entrepreneurial instincts—some of the latent entrepreneurial instincts—in people. You need to train people to become part and parcel of a team and to think of themselves as a team rather than just as a worker. When they become employee stockholders, they suddenly become a different person. The point is, they don't realize this. You take a youngster who is 21 years old and who has the first gleam of a paycheck in his eye, that's all he thinks about, is the money. But then over 2 or 3 years, he begins to realize what he really has invested; he is investing his life in something that is far more important and that has an asset value. And as we begin to train into him, I can tell you, there are miracles that take place.

Senator Long. Well as I understand it, as compared to the Treasury position, you don't want the employee to be permitted to sell his stock and divest himself and remain with the company; you want him to be a partner, as I understand it.

Mr. Braun. Exactly.

Senator Long. You want him to stay with the company and become rich rather than sell the stock at the first opportunity.

Mr. Braun. Sure. And that's where the productivity gains first place, when the employee stays with the company, knows the company, and makes the company grow. And it is his stock that is growing.

In fact, the marvelous part about this, it makes the most ideal retirement program you could ask for, because what it does, it puts the man's investment in the very thing that he can influence the value of.

Senator Long. With the kind of progress your company has been making, about how much would the average employee be able to claim in stock after he has worked for the company for 20 years?

Mr. Braun. Roughly a quarter of a million dollars.

Senator Long. Assuming it continued to go that well for 30 years, about what could he claim?

Mr. Braun. Probably $1.4 million, at the present rate of growth.

Senator Long. That wouldn't be a bad company to work for. [Laughter.]

The Chairman. Senator Long is retiring next year. [Laughter.]

Senator Long. Well, Mr. Braun, let me just say again, I am all for you continuing with your good work. And I think it honors all those who have been working in employee stock ownership that the association picked you, one of the small companies of the association, because what you lack in numbers you certainly have in quality.

Mr. Braun. Thank you, Senator Long.

The Chairman. Let me ask you a question, Mr. Braun. This totally off the track of ESOP's. You talked about the 21-year-old kid's first paycheck, and all he or she is interested in is the money because they haven't had any other training.

Mr. Braun. Yes, sir, that is correct.

The Chairman. If that employee at age 21, not having had any other job, was given an option and the employer would provide health coverage, or just given the cash and go out and buy some health coverage if he wants, do you think a fair number of those employees would just take the cash and not buy health coverage on their own?

Mr. Braun. You'd better believe it. I can tell you, because we just went through a program of changing our health insurance to make some of it optional. And I can tell you about the younger employees who got it in cash. All they did was say they didn't want the extra insurance coverage, they wanted the cash. You know, "callow youth," being what it is, is a pretty good definition for it. They don't think beyond the next paycheck.

The Chairman. And what will eventually happen when enough of them get injured or enough of them wish they had coverage is, they will vote for somebody who will give them national health insurance.

Mr. **Braun**. Senator, we had exactly that situation happen. We had an employee who had an accident on a motorcycle. He just tore himself up something terribly, and he had not enough money to pay all of it.

It is a sad commentary that people will not look far enough ahead. They don't plan, they don't set anything aside for themselves, they are not really concerned about setting for themselves a lifetime financial goal. That only comes after they have got the second or third kid.

Senator **Long**. If I might just interrupt, Mr. Chairman.

The **Chairman**. Sure.

Senator **Long**. I would like to tell, Mr. Braun, what was said when one of these people went out to explain employee stock ownership to the employees. What was the first question that they asked when they got through the hearing about the benefits of the employee stock ownership plan.

Mr. **Braun**. They said, "Can I have money in place of the piece of paper that the stock ownership represents?" It takes 6 months or more to be able to get the first favorable impression in the employees' minds.

Senator **Long**. I thought you were going to tell this story, which is a true story, about the man who spoke for an hour explaining about employee stock ownership and all of the benefits, and then asked, "Now any questions?" And the first question was, "What is stock?" [Laughter.]

Mr. **Braun**. That statement is not apocryphal; it's true.

Senator, there is one other tale. I notice I am out of time, but may I continue?

The **Chairman**. We're out of time, you are not out of time. Go ahead.

Mr. **Braun**. We had one rather elderly gentleman—and I would use that term in our vernacular, Senator. He had retired out of the farming business. He had had a disability because of a tractor accident. He had gone to a community college and has equipped himself to become a technician in our organization. When we introduced the ESOP concept—his name is Gilbert Counts, so he is not a fictional person—one day I came into the parking lot and noticed there was a Cadillac sitting there with a gold radiator. I said, "Whose car is that?" And they said, "Well, that's Gilbert's car." I said, "Well, he is a technician working in this company." They said, "Well, you really ought to talk to Gilbert." So I brought Gilbert in; I said, "Gilbert, I notice that you have got a Cadillac, and I very much admire that car." I said, "What caused you to buy it?" He said, "Mr. Braun," he said, "I've always wanted to buy a car like that, but," he said, "until I got the stock in the company I never felt secure enough to make that investment." That's a true tale, sir.

The **Chairman**. Thank you. It has been a very good panel and a good morning. We are adjourned.

[Whereupon, at 12:25 p.m., the hearing was concluded.]

[By direction of the chairman the following communications were made a part of the hearing record:]

AMERICAN COUNCIL ON EDUCATION
Division of Governmental Relations

August 9, 1985

The Honorable Bob Packwood
Chairman
Committee on Finance
United States Senate
SD-219 Dirksen Senate Office Building
Washington, DC 20510

Dear Mr. Chairman:

On behalf of the American Council on Education, an association representing over 1,500 colleges, universities, and other organizations in higher education, and the associations listed below, we are writing to express our concerns over the effects of the President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity, released May 29, 1985, on employee benefits provided by institutions of higher education. We hereby request that our letter be included in the printed record of the Committee's hearings on these issues held on Thursday, July 11, and Friday, July 19, 1985.

Although this statement focuses on the President's proposals affecting pension plans provided to employees of colleges and universities, the higher education community is also vitally interested in several other employee benefit issues. In a written statement filed with the Committee on July 9, 1985, and cosigned by eighteen associations, we noted the likely devastating effects of the President's proposed uniform nondiscrimination rules on tuition remission plans offered to employees and their spouses and dependents, expressed our support for the President's proposal to make permanent the tax exclusion for employee educational assistance, and urged the Committee to adopt an exclusion for certain faculty housing benefits. Our statements on these issues are hereby incorporated by reference into this letter.

Overview of the President's Proposals Regarding Retirement Plans

The President's proposals would adversely affect the pension plans at public and private colleges and universities in two principal ways that would, in particular, substantially impair their ability to adopt a successful early retirement program. First, by restricting contributions to annuities provided under section 403(b) of the Internal Revenue Code, the proposal would unduly restrict the ability of institutions of higher education to make up for inadequate pension benefits by contributing to the predominant pension vehicle designed for and used by most public and private institutions. Second, by imposing restrictions on certain unfunded deferred compensation arrangements for employees of tax-exempt organizations, the President's proposal would further restrict their ability to make up for otherwise inadequate pension benefits. These proposals would also unduly restrict the ability of employees of private and public colleges and universities to supplement their pension income through contributions of additional amounts to section 403(b) annuities or under unfunded deferred compensation programs.

One Dupont Circle, Washington, D.C. 20036-1193 (202) 833-4736

In addition, we have been informed that the Congress may be contemplating changes in pension plan regulation other than those contained in the President's proposal. We are generally concerned regarding the effect of such changes on benefit plans at colleges and universities and would be particularly concerned over any attempt to apply nondiscrimination rules to section 403(b) pension plans provided at those institutions. We do not believe that nondiscrimination rules are needed to ensure suitable retirement arrangements for clerical/service employees, and the application of such rules would introduce major administrative complexitites and costs in attempting to compare quite different types of retirement programs.

We believe that the restrictions on pension benefits contemplated by the President's proposal are unwarranted and would impair the ability of institutions of higher education to attract and retain qualified employees. These institutions are limited in the salaries they can pay to their employees, and flexibility in their pension plans is vital to their ability to attract and retain qualified faculty. We strongly urge you to oppose the President's proposal in its present form, to work to modify the proposal to preserve these retirement benefits, and to assure that tax reform is not achieved at the expense of our nation's system of higher education.

I. Proposed Restrictions on Section 403(b) Annuities

The President's proposal includes a number of restrictive provisions limiting the benefits available under section 403(b) annuities. These annuities are a special type of pension arrangement created for the pension plans of private and public colleges and universities which are also available to public educational organizations and certain other tax-exempt organizations (e.g., private schools). Most of the pension plans at colleges and universities throughout the nation have been formed under section 403(b), which was enacted in 1942 to ratify the principal then-existing college retirement arrangement introduced in 1920 and to provide higher education institutions the same tax deferral of employer pension contributions that was accorded to qualified pension plans.

A. Proposed Limit on Annual Contributions

The President's proposal would eliminate certain special rules which permit educational institutions, under specific circumstances, to make contributions to section 403(b) annuities in excess of the generally applicable defined contribution plan limits. These special rules are not available to all organizations described in section 403(b), but are expressly designed to meet the needs of educational organizations, hospitals, home health service agencies, and certain church organizations. These rules were included in current law based on a congressional belief that these employer groups display "a pattern of low contributions in the early stages of their [employees'] careers, with relatively high 'catch-up' contributions made late in their careers."

These special pension provisions were intended to and have been used by colleges and universities to provide additional contributions (and, therefore additional benefits) where retirement benefits would otherwise be inadequate. Inadequacy under section 403(b) defined contribution plans can result from the following: (1) early retirement; (2) low career compensation base compared with current compensation; (3) plan inadequacy during early career; or, (4) unfavorable investment experience. Providing such additional benefits is relatively simple under a defined benefit plan, because section 415 of the Code limits only the benefits paid under these plans; the employer can contribute whatever the extra benefit costs without creating an employee tax liability. However, the limits for defined contribution plans would, in most cases, preclude the necessary additional contributions to provide an adequate retirement benefit in the above situations if the current special rules in section 415(c)(4) were eliminated.

The defined contribution pension plan funded by individual annuity contracts is the one most suited to the portability feature of the college and university national pension system. By eliminating "catch-up" provisions designed to respond to the particular needs of educational institutions, the President's proposal would seriously impair the ability of these institutions to provide adequately for the retirement needs of their employees.

Moreover, no justification is given for the proposed repeal of these provisions. The proposal does not challenge the congressional judgment on which the special rules were based, and no claim is made that these rules have been subject to abuse. The proposal would achieve "simplicity" but only by disregarding the needs of employees of educational institutions, churchs, and hospitals.

B. Proposed Restrictions on Distributions

The President's proposal would also severely restrict distributions from section 403(b) annuities. First, the proposal would prohibit distributions prior to separation from service, the attainment of age 59 1/2, death, or disability. Unlike the current rules for "custodial accounts" on which these restrictions are based, no provision would be made to allow distributions in cases of "financial hardship."

Second, the proposal would impose a non-deductible 20 percent recapture tax on distributions made by a section 403(b) annuity to an individual before the individual's death, disability, or attainment of age 50 1/2. If the distribution were used to pay for a dependent's college expenses, for the purchase of the indivdual's first principal residence, or to replace unemployment benefits, the recapture tax would be reduced to 10 percent. As under current law, distributions from a section 403(b) annuity would result in taxable income to the recipient. Thus, the recapture tax would be in addition to whatever income taxes would apply.

Finally, the President's proposal would require distributions by a section 403(b) annuity to commence no later than April 1 following the year in which the individual attains age 70 1/2 or, if later, the year in which the individual retires. Thereafter, both lifetime and after death distributions would be required to conform with minimum payout schedules. Failure to satisfy these rules would result in a non-deductible excise tax equal to 50 percent of the amount by which the required minimum distribution exceeds the amount actually distributed. By contrast, under current law section 403(b) annuity benefits are not subject to minimum distribution rules for the period during which the holder of the annuity remains alive.

The President's proposal would greatly reduce the flexibility available to a beneficiary of a section 403(b) annuity and would also reduce the willingness of employees of institutions of higher education to use salary deferral arrangements to defer compensation until retirement. A signficant factor affecting salary deferral arrangements is the employee's ability to access these funds to provide for pre-retirement emergencies. Failure to permit withdrawals for financial hardship would have a negative effect on employee savings for retirement. The imposition of a minimum payoff schedule on the one hand and the restriction of early distributions on the other would compromise the ability of employees to structure their own retirement. In addition, the proposed restrictions on section 403(b) annuity distributions would add complexity to the retirement planning process, and, as such, would appear to be inconsistent with one of the goals of the President's proposal, simplicity.

II. Proposed Restrictions on Unfunded Deferred Compensation Plans

In 1978, the Department of the Treasury published a proposed regulation stating that elective deferral of income constituted constructive receipt. The proposed regulation was contrary to existing case law, as well as previous Internal Revenue Service rulings, and was apparently designed to encourage the Congress to act in this area. Congress did act later in 1978 by adopting a modified constructive receipt rule for amounts deferred under either a "private deferred compensation plan" available to employees of taxable organizations, or an "eligible State defered compensation plan" available to employees of state and local governments. Neither of these plans is available to employees of private, tax-exempt organizations, such as independent institutions of higher education. It appears that notwithstanding the proposed regulation, exempt organizations may choose to defer compensation under nonqualified and unfunded arrangements without their employees being subject to tax on the deferred amounts until such amounts are actually received.

The President's proposal would alter the status quo by subjecting private tax-exempt organizations (including independent educational institutions) to the same limits on elective deferred compensation as are currently applicable to state and local employees. Employees of such organizations could avoid current taxation of deferred amounts only under an "eligible deferred compensation plan." Compensation deferred under an ineligible deferred compensation plan would be taxable to the employee as soon as there was no longer a "substantial risk of forfeiture."

The President's proposal would also modify the rules currently applicable to eligible state deferred compensation plans by providing that: (1) the projected benefits payable over the lifetime of the employee must exceed 66 2/3 percent of the total projected benefits; (2) if payments are to be made over a period extending beyond one year, they must be made at least annually and on a substantially non-increasing basis; and, (3) distribution of benefits to an employee's beneficiary must commence within one year following the employee's death.

The impairment of the ability of a college or university to make up for otherwise inadequate pension benefits that would result from the elimination of the special elections under section 415(c)(4) would be exacerbated by the proposed extension of section 457 to independent colleges and universities and other tax-exempt organizations. This would probably eliminate completely the ability of a college or university to use an unfunded deferred compensation arrangement to supplement benefits under a defined contribution plan.

The current provisions of section 457 indicate that they were designed to limit voluntary discretionary contributions by employees outside of pension plans (primarily under salary reduction arrangements). It would not be essential to retain section 415(c)(4) and exclude institutions of higher education from section 457 if some other substitute were provided to permit a reasonable make up at or near retirement for an inadequate defined contribution benefit.

III. Effect of Nondiscrimination Rules on Section 403(b) Annuities

Extension to section 403(b) of the "qualified plan" nondiscrimination rules would be destructive of the need to preserve flexibility in the pension plans of colleges and universities. Faculty members, more than any other employee group, are very mobile and present unique problems because of permanent faculty transfers, leaves of absence, and visiting professorships. Preservation of this mobility is extremely valuable to institutions for intellectual stimulation and curricular expansion. However, to achieve mobility there must be assurances that retirement benefits will not be lost or impaired.

In addition, colleges and universities compete in two markets for employees: 1) a national market for faculty and senior administrative personnel; and, 2) a local market for clerical/service employees. Faculty pension plans are generally fully funded and immediately vested defined contribution plans funded by individual annuity contracts, whereas clerical/service plans are generally defined benefit plans with delayed vesting.

Under the current section 403(b), there may be continued contributions by a temporary, tax-exempt employer during leaves of absence from a college or university. Furthermore, an institution can make contributions for a visiting professor without imposing service eligibility requirements and at the level at which contributions were made by the visiting professor's regular employer, even if that level is different from the contribution level for its own employees.

The current "comparability" test for qualified plans would not provide the same relief as section 403(b) because: 1) the admininstrative cost of showing comparability is always very high; 2) the difference between the two types of plan is dramatic and makes comparability very difficult to illustrate; and, 3) the general requirement that clerical/service employees of public institutions must be in the employees' retirement system, while faculty are either in a different state retirement system or are permitted or required to participate in a private plan (such as the Teachers Insurance and Annuity Association - College Retirement Equities Fund) is a complicating factor.

Conclusion

Private tax-exempt organizations perform invaluable national services. By providing teaching, research, and other services which would otherwise have to be performed by government, independent colleges and universities reduce the need for greater levels of government spending and ensure the diversity that is a hallmark of our nation's system of postsecondary education. In recent years, independent institutions have been subject to increased financial pressure that has impaired their ability to provide their employees with compensation commensurate to that which they could obtain elsewhere. Independent colleges and universities are therefore increasingly unable to attract the most qualified personnel.

By restricting the tax benefits available to these employees, the President's tax reform proposals would exacerbate an already serious problem. Both independent and state-supported institutions of higher education would be hard-pressed to obtain the funds necessary to compensate their employees for the loss of these valuable retirement benefits. Teachers, researchers, and other employees of these institutions could therefore be pressured into seeking employment elsewhere, with potentially disastrous consequences for our higher education system in general and for independent colleges and universities in particular.

We therefore urge the members of the Committee to weigh carefully the retirement provisions of the President's proposals with a view to their likely effects on postsecondary institutions and their employees. If you have any questions regarding this issue, please feel free to call on us for further information.

This letter is sent on behalf of:

American Association of Community and Junior Colleges
American Association of State Colleges and Universities
American Council on Education
Association of American Universities
Association of Catholic Colleges and Universities
Association of Jesuit Colleges and Universities
Association of Presbyterian Colleges and Universities
Association of Urban Universities
Council of Independent Colleges
National Association of College and University Business Officers
National Association of Independent Colleges and Universities
National Association of Schools and Colleges of the United Methodist
Church
National Association of State Universities and Land-Grant Colleges

Very truly yours,

Sheldon Elliot Steinbach

Sheldon Elliot Steinbach
General Counsel

SES:gfr

STATEMENT OF
THE AMERICAN COUNCIL OF LIFE INSURANCE

on
The Impact of the Administration's Tax Simplification Plan on Employee Benefits

Submitted to the Committee on Finance
of the United States Senate

July 19, 1985

The following statement is submitted on behalf of the American Council of Life Insurance ("ACLI"). The ACLI is a trade association representing 627 life insurance companies that, in the aggregate, account for approximately 95 percent of the life insurance in force in the United States, hold 93 percent of the assets of all United States life insurance companies, and hold 97 percent of the assets of all insured pension plans. Many of the members of ACLI also write health insurance. The Health Insurance Association of America, the National Association of Life Underwriters, and the Association for Advanced Life Underwriting have also endorsed the views contained in this statement.

INTRODUCTION

We are grateful that this Committee is holding hearings to look into the impact that the Administration's proposals would have on employee benefit programs.

The life insurance business is sympathetic with the broad objective of tax reform. We support the concept that all taxpayers should pay their fair share of the tax burden. However, we are concerned about the very adverse consequences that these proposals will have on employers and employees who sponsor and participate in employee benefit plans, including pension plans.

For almost half a century, Congress has encouraged American business and labor to create and maintain employee benefit programs for the security of the nation's workers and their dependents. A key element in providing support for these private sector efforts has been the tax treatment afforded certain benefits under current law. This tax treatment has produced impressive results at minimum cost to the government, all illustrated by the following statistics:

o Employee benefits are available everywhere.

One hundred and sixty-two million American workers and their dependents are protected by an estimated one-half million employee benefit plans. A 1984 U. S. Department of Labor survey found that 96 percent of all workers in medium- and large-sized firms were covered by group life insurance. A similar percentage were covered under group health insurance plans.

- Employee benefits help low- and middle-income families most.

Seventy-five percent of employees covered by employer-sponsored life, health and pension plans earn less than $25,000 per year. Seventy-four percent of the employer monies placed in pension funds are targeted for individuals with incomes less than $50,000. Pension and group life and health insurance coverages are widely distributed among all income groups.

These very significant achievements in providing financial protection for American workers would be endangered by the Administration's proposals. Several of these proposals deal with areas in which benefits are often provided by life insurance company contracts -- namely:

A. Health insurance premiums (up to $120 per year for individuals and $300 for family coverage) paid by the employer would be taxable to the employee;

B. Popular 401(k) retirement savings programs would be severely restricted;

C. New complex non-discrimination tests would be applied to various employee benefits -- including welfare benefit plans;

D. The special 10-year averaging provision for certain lump sum distributions from pension plans would be repealed; and

E. A myriad of changes would be made with regard to retirement savings, including significant cutbacks in the treatment of Section 403(b) annuities.

To support its recommendations to make these drastic changes, the Administration argues that, if these recommendations were enacted, the tax laws could be simplified and tax rates could be reduced. In fact, the Administration's proposals relating to employee benefits are not simple and will result in increased taxes on plans providing important financial security. These changes could completely reverse long-standing policies to encourage the growth of private retirement and welfare benefits. Such changes would ultimately lead to less private coverage and would undoubtedly result in a demand for increased federal expenditures to take up resultant slack in these areas.

Most taxpayers oppose changes in the tax system that would tend to undermine their economic security -- a view clearly confirmed by public opinion surveys we commissioned earlier this year. A survey conducted by the Roper Organization revealed that both the general public and chief executive officers of major corporations are overwhelmingly against taxing employee benefits.

In fact, more people think we should consider raising income taxes than think we should consider taxing employee benefits.

The balance of our statement will detail each of the Administration's proposals on employee benefits and our comments.

The Administration's proposals would also impose tax increases on individual life and health insurance customers and on life insurance companies. These proposals are of equal concern to us and we intend to address them in detail when your Committee holds hearings on this segment of the Administration's proposals.

A. PROPOSED TAXATION OF EMPLOYEE HEALTH CARE BENEFITS

Under current law, employers are allowed to deduct contributions made to an employee health benefit plan, and employees are not required to include these amounts in their taxable incomes. The Administration's proposal requires employees to add to their incomes for tax purposes the amount their employer contributes to an employee health care benefit plan, up to a maximum of $120 per year for individual and $300 per year for family coverage.

Why the Proposal Should be Rejected

1. Enlightened tax policy, coupled with initiative by management and labor, has resulted in comprehensive health care coverage for the great majority of working Americans. **Today, over 162 million Americans under age 65 are covered by group health insurance. Eighty percent or more of covered workers earn less than $25,000.**

Employer-provided health care benefit plans are one of the most sought-after and necessary employee benefits available. They provide vital financial help to preserve the health of American workers and their families and they are an essential part of collectively bargained and other wage and benefit programs.

For many years, tax policy has encouraged comprehensive health care coverage for a major segment of working Americans. Consequently, today the overwhelming majority of working Americans have health insurance protection for themselves and their families, provided in part through employer contributions. At the end of 1982, 162 million Americans under age 65 were covered by group health insurance policies. Eighty percent or more of covered workers earned less than $25,000.

The Employee Benefit Research Institute, in testimony before the Senate Finance Committee on July 26, 1984, stressed that current tax policy has increased coverage significantly for lower-income households, households with fragmented employment history, younger households and single-person and single-parent households. The insurance industry has emphasized that the encouragement of health benefit plans through tax incentives has been enormously successful. It has stimulated comprehensive coverage for most working Americans. Working people have come to regard employer-sponsored health protection as virtually an automatic feature of employment providing invaluable benefits.

2. There is virtually no logic in terms of either social or tax policy to support the creation of a tax liability associated with the receipt of employer-sponsored health benefits.

Under our current system, no major tax incentive is as socially valuable or as progressive as the exclusion of employer contributions to health benefit plans. Only about 13% of the health tax incentive benefits those with incomes above $50,000 -- compared to 30% of the benefit of the homeowner's mortgage interest deduction, 64% of the capital gains exclusion and 55% of the deduction for charitable contributions. Yet, in the name of horizontal equity, the tax reform proposals have singled out health benefit plans as the source of new revenue -- even though the benefits under these plans are more equitable, horizontally, than any other major tax incentives.

The American people are on record as being against a tax on health care benefits. In a recent Roper Survey, 80% of the population opposed the taxation of their health benefits as a way to raise tax revenues, even if the purpose was to lower tax rates.

3. Taxing employer-provided health insurance is fundamentally unsound whether the tax is in the form of a floor, a cap or in some other form.

The Cap

The original Treasury proposal would have limited the amount an employer could contribute to an employee health care benefit plan without a tax to the employee. That cap was $70 per month for an individual and $175 per month for a family. The problems associated with such a tax cap are numerous.

The burden of a tax cap would fall unequally on workers depending upon where they work, their ages and their occupations. Taxing group health insurance this way would discriminate against workers in high health care cost areas -- California and New York for example -- where the cost of health care coverage can be three to four times the cost of the same coverage in other areas of the country. A tax cap would also have its heaviest impact on groups composed primarily of older workers whose health care costs are more than those for younger workers.

A cap would discriminate against workers employed in high-risk or hazardous occupations since higher health premiums must be paid to cover the risks. A cap would place essential preventive health care in jeopardy since employers would be discouraged by the cap from making contributions for other than catastrophic coverage. Finally, a cap would involve difficult and costly problems of administration and reporting.

The Proposed Floor

The Administration now proposes a tax which would impute income of up to $10 per month ($120 per year) for individual coverage of an employee or $25 per month ($300 per year) for family coverage for health care benefits -- in effect a "floor" instead of a cap.

The floor concept avoids some of the worst inequities and problems posed by the cap. The floor is administratively simpler (at least at the initially proposed levels). The floor would be less burdensome and more equitable than the cap to the aged, the sick, those in higher risk occupations and workers in regions of the country where health care is most expensive. Further, the floor would not selectively discourage coverage for important preventive health services while a cap would. Nevertheless, the floor would still represent a tax on employee health benefits and we remain opposed to such a tax in any form.

There are other problems with the floor. Because the bulk of health benefits go to lower- and middle-income workers, any tax on these benefits will hit hardest on lower- and middle-income families. This problem is accentuated under the floor concept. The floor would not only mean increased income taxes but increased social security taxes as well for most lower- and middle-income workers. While many of these workers would have increased income taxes and social security taxes under the cap, nearly all would be faced with this problem under the floor. As the table below illustrates, nearly one-third of the total tax revenues raised by the floor would come from the payroll tax:

	1986	1987	1988	1989	1990
Income Tax Revenues ($ bil.)	2.4	3.5	3.7	3.8	4.0
Social Security Tax Revenues ($ bil.)(employer + employee)	1.1	1.6	1.7	1.7	1.9

[Social Security Estimates Prepared by the ACLI]

Among lower- and middle-income families, this increase in social security taxes would offset to some extent any benefits they might derive from other Administration proposals.

Also, under the floor concept people who receive different health care benefits would be liable for the same tax. Those whose coverage was limited to a contributory hospital benefit plan would pay the same tax as those in the same tax bracket in a non-contributory comprehensive health insurance plan.

In effect, structuring the tax as a floor eliminates some serious inequities posed by the cap, but presents other problems. More critical in our view, however, is that regardless of how a tax on health benefits is structured, it will introduce a disincentive for employees to continue their health insurance coverage. This should be the overriding concern since the degeneration of plans that will ultimately follow will move the burden of providing health care to the government. This would be a terrible mistake. Over the years, the favorable tax treatment of employee benefit programs has fostered a remarkably effective partnership composed of the government, employers and employees. We believe it is an arrangement that is far too successful and valuable to be jeopardized by an ill-conceived and destructive tax.

4. The taxation of health benefits now would create an undesirable precedent, leading inevitably to higher levels of tax as the need for federal revenues increases.

The tax on health benefits under the Administration's proposal also lends itself readily to substantial increases in tax revenues by merely raising the maximum amount includible as imputed income. The prospect would be that, with the precedent in place, health benefits would become a natural source for new tax revenues. It could signal the beginning of the end for employer-provided health care plans and an irreversible movement of the cost of providing health care to the government.

B. PROPOSED RESTRICTIONS ON SECTION 401(k) PLANS

Section 401(k) plans, also called "CODAs" (cash-or-deferred arrangements), were first permitted by the Revenue Act of 1978. Since 1982, these plans have rapidly become an important element in retirement savings and are, perhaps, the most popular benefit available judging from the number of plans being implemented.

401(k) plans are employer-sponsored programs that permit employees to defer current compensation to meet future financial needs. Amounts contributed to the plan are not includible in the employee's gross income at the time of contribution, provided specific requirements are met.

The Administration's proposal would not repeal Section 401(k); however, it would modify elective contribution limits, non-discrimination tests, distribution rules and employer matching contribution provisions applying to CODAs.

The proposal would limit an employee's contribution to a 401(k) plan to an unindexed $8,000 less any IRA contribution. The current "ADP" (Actual Deferral Percentage test, i.e., the formula for determining allowable contributions based on non-discrimination standards) would be modified in three ways: the definition of the prohibited group would be altered; the allowed difference between contributions made by members of the prohibited and non-prohibited groups would be reduced; and the test would be applied to the individual deferral ratios rather than the aggregate ADP for the prohibited group. Distributions of elective contributions would be allowed only at death, disability, separation from service or plan termination; currently distributions may also be made in hardship situations. Employer matching contributions would be subject to the same ADP test as employee elective contributions, and under some conditions to a more severe ADP test.

While all tax-favored retirement plans, including profit-sharing plans, would be subject to a strict non-discriminatory coverage test, a different eligibility test would apply to CODAs. The fraction of the prohibited group members eligible to make elective contributions could not exceed 125% of the analogous ratio of other employees.

Finally, CODAs could no longer be maintained by exempt organizations and governmental units on a tax-qualified basis.

Why the Proposal Should be Rejected

1. CODAs are more like other qualified employer-sponsored retirement plans than they are like IRAs. It is therefore inappropriate to impose additional IRA-type limits on the contributions.

CODAs are qualified employer-sponsored retirement plans. An elective contribution under a CODA has the same tax effect for the employee as a deductible contribution by the employer to any other qualified employer-sponsored defined contribution plan, such as a traditional profit-sharing plan or a money purchase pension plan. Furthermore, CODAs must meet strict contribution and distribution rules, anti-discrimination and eligibility requirements, coverage tests, participant loan rules and employer deduction rules. Importantly, under the Administration's proposal, the anti-discrimination tests for CODAs are significantly more rigorous than the general anti-discrimination rules applicable to all other qualified employer-sponsored retirement plans.

Any tax reform proposal should provide similar tax advantages to, and impose similar restrictions on, employees of employers maintaining CODAs as apply to alternative qualified employer-sponsored retirement plans. Thus, an employee's elective contributions to a CODA should be subject to the aggregate contribution limits applicable to "annual additions" to an employee's account under all other qualified employer-sponsored defined contribution plans. (Current "annual additions" to an employee's account or accounts may not exceed the lesser of: (a) 25% of the employee's compensation, or (b) $30,000. See IRC Section 415.) The possibility of the employee making an IRA contribution in any particular year does not affect the defined contribution limit and should not affect the employee's contributions to a CODA.

The reasons for the tax-favored treatment of qualified employer-sponsored retirement plans and the accompanying limitations on these plans are very different from the reasons for IRAs. The tax benefits applicable to IRAs are intended to encourage individuals to save on their own initiative for retirement. The broad and consistent availability of IRAs for individual retirement savings should, of course, be encouraged. On the other hand, qualified employer-sponsored retirement plans have long been recognized as a broad-based, non-discriminatory way of providing for the retirement of a great number of employees. Cash or deferred arrangements have been an optional qualified employer-sponsored retirement plan since 1956 and since 1980 have rapidly become an important primary or supplemental employer/employee retirement plan. It is illogical to single out one type of employer-sponsored retirement plan, the CODA, and subject this plan to both an arbitrary dollar limit and integration with individual retirement savings options. Therefore, CODAs should be given parity with other profit-sharing plans when setting contribution limits.

2. The IRA integration requirement will generate severe administrative problems and associated expenses for 401(k) plan sponsors and confusion for participants.

Sponsors of 401(k) plans naturally have no information on the extent to which the employees are participating in and contributing to IRAs. Although, in principle, the employees will have to monitor their contributions to both arrangements and deal with any excess contributions, in practice much of the burden will fall on the 401(k) plan administrator.

Employees who receive raises after having made IRA contributions will request projections of their 401(k) contributions and modifications of their deferral ratios. Employees who miscalculate their allowable contributions will at year-end, or even in the following year, seek to retrieve contributions or to reallocate deferred to non-deferred contributions. Employers will have to establish elaborate administrative rules and procedures. Employees will be confused and disgruntled and participation will be adversely affected.

3. The $8,000 contribution limit would significantly disadvantage employees in businesses which cannot afford an additional retirement plan.

In 1981, the President's Commission on Pension Policy identified coverage as one of the key problems of private sector plans. It was concerned that only half of the work force was covered under retirement plans. In many instances, CODAs are established by employers who could not otherwise afford to sponsor a qualified retirement plan for their work forces. A nationwide survey, commissioned by the Employers Council on Flexible Compensation, indicated that almost a half-million small businesses offer 401(k) plans to their employees. For 37% of those businesses, the 401(k) plan is the only retirement program.

The popularity of CODAs is due, in part, to their value as a lower-cost employer-sponsored retirement plan. Through salary reduction, employees are able to maximize the value of their retirement savings beyond those amounts, if any, which the employer could afford to contribute on their behalf under a more traditional arrangement, or which they would receive directly in a plan where there were only non-deductible employee contributions. A contribution limit as restrictive as the IRA-integrated $8,000 ceiling in the Administration's tax proposal would, in practice, discriminate against employees of those employers unable to maintain conventional retirement plans.

4. The new ADP test will be nearly impossible to administer; it will be unfair; and it will drastically reduce allowable contributions in 401(k) plans that are clearly not abusive.

Section 401(k) plans must currently meet a two step anti-discrimination test known as the Actual Deferral Percentage ("ADP") test. The ADP test first expresses each employee's plan contributions as a percentage of his compensation. The ADP test then computes an average deferral percentage for the whole group of highly compensated employees and compares this average with an average deferral percentage computed for the group of non-highly compensated employees. The new ADP test, based on individual deferral ratios, is unworkable, unfair and too restrictive.

First, in an ADP test based on aggregates for both non-prohibited and prohibited group members, it is not necessary to monitor individuals' contributions precisely. The volatility and uncertainty associated with individual behavior are smoothed out in the averaging process. If high income individuals have to meet an individual test, most will not know whether they are in violation of the ADP test until near the end of the calendar year for which contributions are due. This will result inevitably in confusion and unproductive administrative expense.

Second, the new test will be unfair inasmuch as similarly situated individuals will be allowed to make drastically different contributions. An individual employee in the non-prohibited group could quite easily have a deferral ratio twice that allowed all employees in the prohibited group. Therefore, two employees, earning similar salaries, one in the prohibited and the other in the non-prohibited group, would be allowed substantially different benefits under the plan.

Finally, the overwhelming majority of existing plans, carefully designed by responsible employers to be non-discriminatory, would fail the new ADP test. In order to pass the test, all members of the prohibited group would have to drop their deferral ratios to levels very close to the average ratio for non-prohibited group members. This is clearly excessively restrictive and goes far beyond preventing any perceived abuse.

5. The rules covering the distributions from CODAs should be no more onerous than those for other qualified plans.

Any tax reform proposal should ensure that the rules for distributions from all qualified employer-sponsored retirement plans are generally uniform. Despite the economic equivalence between CODAs and other qualified employer-sponsored retirement plans, the Administration's tax proposal would establish rules for distributions from CODAs which excessively penalize employees participating in CODAs. The proposal establishes uniform early distribution rules for all employees participating in qualified employer-sponsored retirement plans, except CODAs. The proposed uniform rule permits distributions prior to 59 1/2 years of age subject to an excise tax. The CODA proposal prohibits distributions to active employees. The CODA distribution rules should be modified to permit employee elective contributions to be distributed on the same basis as distributions from other qualified plans.

6. **There is no sound reason to limit the flexibility of tax-exempt and public sector employers and the equal opportunity of their employees to participate in 401(k) plans.**

Employees of tax-exempt institutions and the public sector should have the same right to participate in tax-favored retirement plans as all other employees. Since the plans sponsored by public sector and tax-exempt employers are subject to the qualified plan overall maximum contribution or benefit limits (See IRC Section 415), there is no danger of abuse by allowing them to offer 401(k) plans. There is no reason to limit the flexibility of these employers in choosing the most appropriate kind of plan for their employees' needs. Moreover, only a small segment of tax-exempt employers (those exempt under IRC Section 501(c)(3)) are eligible to establish tax-deferred annuities (Section 403(b) plans); thus Section 403(b) plans are not a substitute for 401(k) plans for most employees of tax-exempt employers.

7. The amounts involved under Section 401(k) plans do not escape tax. Taxes are simply deferred until the employee retires and receives the income.

The key feature of a 401(k) plan is that Americans can defer taxes during their working years on income set aside for retirement and then pay taxes on that income as they receive it after retirement. There is no escape from paying taxes.

8. Employer-sponsored retirement plans encourage capital formation.

Private savings and capital formation should be encouraged. One way this goal can be achieved more effectively by Congress is through encouragement of broad-based retirement plans maintained by employers to provide income security for great numbers of employees. Capital formation achieved through employer-sponsored plans will benefit the economy while at the same time employees will obtain the benefit of participation in employee benefit plans such as Section 401(k) plans.

For all of the reasons set forth above, the present rules for Section 401(k) plans should be retained.

C. PROPOSED NEW NON-DISCRIMINATORY COVERAGE REQUIREMENTS FOR EMPLOYEE PENSION AND WELFARE BENEFIT PLANS

Pension Benefit Plans

Current law requires that all qualified employer-sponsored retirement plans meet specific non-discriminatory coverage requirements. The plan must meet one of the following alternatives: (1) the plan must benefit at least 70% of all employees; (2) at least 70% of all employees must be eligible to participate in the plan, and of that group, 80% must benefit from the plan; or (3) the plan must provide benefits to a classification of employees found by the IRS not to be discriminatory in favor of employees who are officers, shareholders or highly compensated. In applying alternative (3), the terms "non-discriminatory classification," "officers," "shareholders," and "highly compensated" are defined by IRS, based on an investigation of the facts and circumstances of each particular case reviewed.

An objective of the Administration's proposal is to assure that "coverage under qualified plans...be made available on the broadest possible basis." To this end, all qualified employer-sponsored plans would be required to satisfy a new non-discriminatory coverage test. Under this test, the percentage of prohibited group members benefiting under the plan may not exceed 125% of the percentage of non-prohibited group members benefiting under the plan. Disregarded for purposes of this test are employees with less than one year of service (or two years of service if benefits are vested immediately, and it is not a 401(k) plan), employees who have not attained age 21, union employees and nonresident aliens. The prohibited group is made up of employees who presently, or at any time during a

3-year look-back period, are: a 1% or more owner; an employee earning $50,000 or more; one of the employees in the top 10% of employees by compensation or one of the highest three employees by compensation, but not if the compensation is less than $20,000; or a family member of a prohibited group member.

Under the proposal, the traditional "non-discriminatory classification" test (alternative (3), above) could be utilized by a plan to demonstrate non-discrimination only "in very limited situations where compelling business reasons" exist and the employer seeks a timely ruling from the IRS.

In addition to the 125% test, any classification used by the plan for defining participation would be required to be non-discriminatory on its face. The IRS would be permitted to define which classifications used by a plan to exclude employees from participation are non-discriminatory. Requiring an employee contribution as a condition of participation or excluding employees in a bona fide job category from participation would be permissible classifications. Also, integration with social security would continue to be permissible.

Why the Proposal Should be Rejected

1. The new non-discriminatory coverage test would create an

enormous administrative burden on plans already attempting to cope with the changes required by TEFRA, DEFRA and REA.

It is generally recognized that employer-sponsored retirement plans are a sound way of providing retirement security for American workers. Aside from maintaining the Social Security system, the most effective means for Congress to assure an adequate living for the greatest number of older Americans is to continue tax incentives for employers to provide for their employees' retirement. Continued tax incentives will not be sufficient, however, if employers are discouraged from maintaining qualified plans due to unreasonable benefit requirements and administrative costs. While we do endorse the application of non-discriminatory requirements to qualified plans, it is necessary that these requirements be simple as well as effective and not unnecessarily displace current plan practices and result in increases in plan administrative costs.

The proposed non-discriminatory coverage test would cause employers to incur substantial administrative expense; and may compel the provision of significant additional and unnecessary benefits. It is likely that, if these qualified plan-related costs are perceived by employers as sufficiently high, the qualified plan will be terminated. Alternatively, employers may decide not to proceed with the institution of a qualified plan.

The proposal notes that "the test would require some qualified plans to provide benefits to additional numbers of non-prohibited group employees." Changes in benefit levels under qualified plans, effectuated solely to meet the new coverage tests, are not appropriate from a long-term pension policy perspective. Part-time and seasonal workers, who can no longer be excluded, will be over-pensioned, and duplication of benefits will result; even full-time rank and file employees will be over-pensioned, if their plans are made comparable to plans which cover professional, high-level or high technology employees. This result is contrary to an expressed policy of the proposal "that favorable tax treatment...be available only up to levels needed for reasonable retirement savings." In response to the need to increase the benefit level of the rank and file, employers will likely reduce the current compensation of this group commensurately. The rank and file will thus face the loss of a more valuable right -- current compensation -- in exchange for the promise of future retirement benefits.

A major purpose of the new coverage requirements is to give the IRS a mechanical enforcement procedure. In our view, the introduction of new regulatory procedures should not be part of a tax reform package. And, as there is no proof that the existing coverage requirements are inadequate, the IRS appears to be experimenting with enforcement procedures, and instituting unnecessarily complex rules, at the expense of plan sponsors and, ultimately, plan participants and beneficiaries.

2. This change, which raises no revenue, concerns national retirement income policy and therefore should be considered only by the appropriate Congressional committees.

National retirement income policy and retirement adequacy legislation is presently under consideration by two of your Subcommittees and the House Committee on Education and Labor. It is counterproductive for the same issues to be involved in the crush of tax reform legislation, when a more deliberate approach is already underway.

3. The new test deprives any business with a variety of operations of the flexibility necessary to fashion benefit programs to best meet the needs of a diverse employee group.

It is common, in today's business environment, for a business with a variety of operations to maintain non-comparable employee benefit plans. The decision not to force all employees of a heterogeneous workforce into a single rigid qualified retirement plan structure is generally based on administrative impossibility and the need to remain competitive in attracting quality employees.

Under current law, benefits may be structured in such a way as to channel certain welfare benefits to those employees who are in greatest need of that type of coverage in lieu of retirement benefits or coverage under a thrift plan. Other employees, whose need for retirement benefits is more important, can, on the other hand, be afforded fewer welfare benefits. Similarly, among different types of qualified plans, coverage is often determined with respect to the best type of qualified plan for a particular salary level, age group or occupational group. This flexibility would be severely restricted under the new coverage test.

4. It is unlikely that coverage will be increased under the proposal's new coverage rules. It is likely that benefits will be made uniform at relatively low levels and the

highly compensated will retain the accustomed level of benefits by the utilization of arrangements outside the qualified plan area, such as non-qualified deferred compensation arrangements.

The proposal recognizes that "the proposed 125% coverage test would...require some qualified plans to provide benefits to additional numbers of non-prohibited group employees tend[ing] to increase the cost of these plans." However, the proposal naively assumes that the coverage test will not precipitate "change to the plans' benefit formulas" and that a plan will "offset any resulting increased costs by reducing the coverage of prohibited group members."

Coverage under qualified plans is already strictly regulated and must be available to employees on a broad basis. In further mandating coverage, a decrease in overall coverage is the likely outcome. To the extent the retirement needs of key employees cannot be met by qualified retirement plans, they will be met by compensation arrangements under which benefits inure generally only to the highly paid. Lower-income employees would, therefore, lose future qualified plan benefits and not benefit from the non-qualified arrangements that are established.

5. The new coverage test will discourage beneficial combinations of businesses. A small business wanting to expand its horizons, in order to enhance its capital and market position, will be dissuaded from continuing to maintain a qualified employee benefit plan.

The proposal recognizes that the new tests would severely affect businesses involved in expansion, yet the proposal makes limited and inadequate concessions in a situation where "an employer maintaining a qualified plan acquires another company and the acquired company did not maintain a qualified plan for its employees."

Merely permitting the resulting company to defer meeting the new coverage test for one year is not a remedy to the problems likely to arise when artificial constraints are placed on business decisions. When employee benefits is made a prime consideration in business expansion, rather than an administrative detail to be worked out after the transaction, small companies will be reluctant to enter into business combinations. If the proposal's new coverage rule prevails, and more adequate adjustment arrangements are not included, small high-technology companies with existing benefit arrangements will be discouraged from combining with a company where qualified retirement benefits have been minimal, despite the economic and financial advantages to such a combination. Similarly, companies with large groups of rank-and-file employees will be hesitant to acquire small, growth-oriented companies with higher salary structures or more generous qualified plans.

Welfare Benefit Plans

Under current tax law, an employee may exclude from income certain employer-provided benefits. With few exceptions, one of the requirements (for exclusion) is that the benefits be provided on a non-discriminatory basis. The non-discrimination requirement applies to many employee welfare benefit plans including group-term life insurance, self-insured medical benefits, dependent care assistance and all benefits in a cafeteria plan (I.R.C. Section 125). No such requirement applies to disability income benefits or insured medical benefits.

The tests for determining whether the benefit is provided on a discriminatory basis are different for each benefit. Thus, the groups of employees that may be excluded for the purposes of discrimination testing, the determination of the prohibited group and the consequences of providing benefits on a discriminatory basis are different for each benefit.

The Administration's proposal would revise the non-discrimination rules for welfare benefit plans in an attempt to make them uniform across different plans. Two results of particular interest to the insurance business flow from these proposals: (1) statutory non-discrimination rules would apply, for the first time, to insured health plans; and (2) the specifics of existing rules would be substantially changed.

We are not opposed to extending non-discriminatory requirements to insured health plans, provided that such requirements are workable and consistent with sound public policy objectives. However, we do not believe that an attempt should be made to develop a new and expanded set of non-discrimination rules for these plans in the context of the current tax reform efforts. Tax revenue, rather than public policy, is bound to be an important, if not overriding, consideration. This should not be the case; instead, the operating rules for these plans should be considered in a broader context by the appropriate Congressional committees.

Moreover, the specific proposals in the Administration's program appear to contain serious flaws. For example, the new "concentration test" would severely discriminate against small employers where the 20-employee prohibited group would be a very large percentage of the total work force. In addition, the requirement that each type and level of benefit be tested as a separate plan unduly restricts an employer's ability to offer flexibility in its benefit plans, is more difficult for smaller employers to satisfy, and is unnecessarily stringent in light of the stated goal. In addition, the "concentration test" measures the actual distribution of benefits under a plan against an arbitrary subset of the prohibited group, resulting in a completely ineffective test for large employers and an overly restrictive test for smaller firms.

D. PROPOSED REPEAL OF THE TEN-YEAR AVERAGING PROVISION

Generally, upon retirement a participant in a qualified benefit plan has an option to receive plan benefits either in a lump sum or in installments. Often the retiree will take the benefit in a lump sum because of immediate financial needs or because of the retiree's health or marital status. Retirees have been free to make this election on the basis of their financial needs and without regard to taxation. The ability to make this choice without regard to taxation has been an important part of the pension benefit made available to them.

More specifically, under current law, certain lump sum distributions from pension, profit-sharing and stock bonus plans are taxed under a special ten-year averaging method which is designed to minimize the impact of progressive tax rates on bunched income.

Under the ten-year averaging method, a separate tax is computed as if the retiree had no other ordinary income and received the lump sum distribution evenly over ten years. To reduce the tax burden on some distributions even further, retirees may receive a "minimum distribution allowance" tax free. The minimum distribution allowance decreases as the size of the distribution increases and is not available with respect to lump-sum distributions of $70,000 or more. As a consequence, and because the progressive tax rates of single taxpayers are used, large distributions are taxed at significantly higher rates than small distributions.

The Administration proposes to repeal the special ten-year forward averaging provision for distributions from qualified plans. The Administration maintains that the special ten-year averaging provision for certain lump-sum distributions encourages these distributions and is inconsistent with providing retirees with income throughout the entire period of their retirement.

The Administration recognizes that the original purpose of the ten-year averaging provision was to mitigate the effect of the progressive tax structure on retirees who receive all of their benefits in a single year. In making its proposal, the

Administration assumes that this purpose would be served by permitting retirees to roll over lump-sum distributions into an IRA so that they would be taxed only as amounts subsequently are withdrawn from the IRA.

Why the Proposal Should be Rejected

1. The Administration's proposal would subject retirees receiving all their retirement benefits in one year to an unjust hardship. Although the Administration's program would reduce the progression in the tax rates, the amount of progression which would still exist would cause hardship for these retirees.

Participants in a retirement plan often make contributions over the lifetime of their employment. The amount of their retirement income, including employer contributions and investment income, is significant at retirement. Subjecting retirees to a one shot retirement tax on these amounts rather than phasing in the tax burden is a significant departure from the treatment originally anticipated when employees began saving for their retirement.

The Administration has noted that the original purpose of the ten-year averaging provision was to mitigate the effect of the progressive tax structure on individuals receiving all their benefits in a single year. While the Administration has reduced the progressivity of the tax rates in its proposal there still exists a 20 point spread in the rates. Thus, retirement plan recipients would still be subject to an unjust hardship if they were to be taxed fully in the year they receive their distribution.

2. Ten-year averaging benefits retirees generally upon distribution of needed retirement benefits.

Ten-year averaging benefits retirees generally at the time of need. Taxation of lump sum distributions from qualified employee benefit plans under the ten-year averaging provision permits these employees or their beneficiaries to receive the money from the pension plan without tax penalty. Under the Administration's proposal, recipients of distributions from a qualified benefit plan would be subject to an unjust hardship because they would be taxed fully in the year they receive their needed distribution.

3. Repeal of ten-year averaging would impair the value of retirement benefits, reduce flexibility and harm employees

who have built retirement programs based on its availability.

The Administration's proposal to eliminate ten-year forward averaging would reduce retirement-planning flexibility for persons with more than one retirement plan who may wish to use the income from the secondary plan for a retirement home purchase or other large expenditure. The number of retirees with multiple retirement plans is increasing because of our mobile population and because of the increasing number of workers who move from one job to another. The number of persons retiring with benefits from more than one pension plan -- benefits they may want to use differently -- is growing and will continue to grow.

4. If ten-year averaging is repealed, repeal should be prospective and all accrued retirement benefits should be entitled to ten-year forward averaging.

The Administration's plan would completely repeal current averaging treatment for pre-retirement lump sum distributions and phase in, over six years, the averaging rules for retirement lump sum distributions. A change of this magnitude and scope affecting millions of retirees and Americans facing retirement will be disruptive and harmful to those who have anticipated the availability of this benefit.

We believe that ten-year forward averaging should be retained in the law. If, however, it is to be repealed, the Administration should consider a true grandfather allowing all benefits which have accrued as of January 1, 1986, to be entitled to ten-year forward averaging. Congress has acted in a similar fashion in the adoption of ERISA in 1974 when it preserved capital gains treatment for that part of the taxable portion of a lump sum distribution which was attributable to the employee's pre-1974 service.

E. PROPOSED MODIFICATIONS TO THE DISTRIBUTION AND DEDUCTION RULES FOR QUALIFIED PENSION PLANS, AND MODIFICATIONS OF THE TAX TREATMENT OF SECTION 403(b) ANNUITIES

The Administration proposes a series of changes to the current deduction and distribution rules applicable to qualified pension plans, and significant modifications of the tax treatment of Section 403(b) annuities. With respect to many of the proposed changes, our testimony briefly summarizes the current law, the proposed changes and their impact. An overriding consideration, however, is our view that the recent trend of piecemeal, revenue-driven changes to the qualified plan rules is wholly inappropriate for dealing with retirement income issues.

Those issues should be addressed in a comprehensive fashion. When employers implement employee benefit plans they make long-term commitments to benefit continuation. For the private employee benefit system to prosper, government must follow a consistent and coherent long-term approach and not continually shift policies. Therefore, any changes impacting the private retirement system should be enacted in the context of a national retirement policy discussion.

TAX ON EARLY DISTRIBUTIONS

Present law discourages distributions from some but not all retirement plans. A 10% excise tax is imposed on distributions from qualified plans to a current or previous 5% owner, or from an IRA to the individual prior to death, disability or age 59 1/2. Profit-sharing, thrift, and 401(k) plans can permit in-service distributions for hardship, if a plan so provides, with no excise tax imposed if the recipient is not a 5% or more owner.

The Administration's proposal would impose a 20% excise tax on the taxable portion of distributions from any tax-favored retirement plan before the participant dies, becomes disabled, or attains age 59 1/2. The tax is reduced to 10% if the distribution is for a dependent's college expenses, purchase of a first principal residence, or replacement of unemployment benefits. Section 403(b) annuities would be made subject to the same distribution restrictions. If the distribution occurs after age 50 but before 59 1/2, amounts distributed will not be treated as a pre-59 1/2 distribution if paid out in life annuity form or in level payments over 180 months.

Our national policy should continue to encourage personal savings and capital formation as integral goals of a national retirement policy. There are serious questions whether existing penalties on early distributions serve or undermine such policy. For example, unless the employee's money has been in the plan for a long time, the penalty more than recaptures any benefit from the deferral of tax on the contribution and earnings. Increasing the penalty to 20% would exacerbate the problem. The whole concept of a penalty, including its purpose and its design, needs to be considered in a broad public policy context. Until then, we cannot endorse existing penalties let alone support the proposed extension of these penalties as proposed, which would encompass hardship situations.

Restricting tax-favored savings solely to provide a narrow definition of retirement income would result in reduced savings. The greatest negative impact would fall on younger and lower-paid workers as many would no longer participate in contributory plans.

In general, the current retirement savings system is successful in providing the major portion of accumulations to employees for retirement. This is accomplished in part by permitting employees some flexibility - by encouraging savings to meet other major needs and by providing a framework for savings. An important social contribution of tax policy favoring qualified plans is to encourage people - either individually or through company plans - to engage in disciplined savings.

CHANGES IN THE TAXATION OF DISTRIBUTIONS FROM CONTRIBUTORY PLANS

Distributions from plans providing for employee contributions, e.g., a thrift plan, are currently treated first as a tax-free recovery of employee contributions. Under a "three-year rule", annuity distributions which include employee contributions are treated first as tax-free recovery of employee contributions if the employee contributions will be recovered within three years. If employee contributions will not be recovered within three years, a fixed portion of each payment is recovered tax-free according to a formula based on life expectancy at the time distributions begin.

The Administration's proposal revises the current basis recovery rules. A withdrawal before the annuity starting date would be treated first as a taxable distribution. Thus, if an employee withdraws money from a plan, all fully taxable savings would be treated as withdrawn first and included in currently taxable income before the employee could have access to his or her own contributions on which taxes have already been paid.

The three year recovery rule would be repealed. Annuity distributions would be taxed according to an exclusion ratio established at the time of commencement based on standard recovery periods of 5, 10, 15, or 20 years, depending on which is nearest to life expectancy. If an annuitant's basis is not fully recovered at death, the deduction passes to the estate or heirs. If the annuitant outlives the recovery period, each additional installment is fully taxable.

Current law should be maintained. All contributory plans would be affected by a reordering of distributions and basis recovery rules. This reordering would be particularly onerous coupled with the tax on early distributions. Thrift and savings plans would be adversely affected as the inability to recover employee contributions first would greatly discourage employee participation, especially among younger and lower-paid workers. Plans maintained by governmental employers are affected as they generally require relatively high levels of employee contributions.

Moreover, the proposed new exclusion rules for lifetime annuities would result in older annuitants suddenly having increases taxable income if they live past their life expectancy, as defined by the Treasury. This could result in real hardship.

PENALTIES ON INSUFFICIENT DISTRIBUTIONS - MINIMUM DISTRIBUTION RULES

At present, qualified plan distributions must commence, in at least specified amounts, by April 1st following the year of attainment of age 70 1/2 or, for non-5% owners, the year of retirement, if later. If insufficient amounts are distributed, plans are subject to disqualification.

Likewise, IRA and SEP (Simplified Employee Pension) distributions must commence by April 1st following the year of attainment of age 70 1/2. If insufficient amounts are distributed, an IRA or SEP owner must pay a 50% excise tax.

Tax-sheltered annuities are subject to no lifetime distribution rules, but are subject to after-death rules similar to qualified plans.

The Administration proposes to replace the sanction of plan disqualification with a 50% penalty tax that would apply to all tax-favored retirement plans, including tax-sheltered annuities. Thus, if the minimum amount required to be distributed exceeded the amount, if any, actually distributed, the difference would be subject to a 50% excise tax. Therefore, if plan distributions are not begun by age 70 1/2, a calculation is made of what should have been distributed that year and a 50% excise tax is levied against that amount even though the individual would have received no funds to pay the tax.

Imposing a 50% penalty on corporate plan participants would miss the target completely. The current penalty tax provisions for IRA's and SEP's are to ensure that "participant-owners" will request distributions which are solely within their control. With a corporate plan, generally it is the plan administrator who controls the timing and sufficiency of distributions. Thus, the Administration's proposal would penalize the employee for a violation made by the plan administrator. It simply does not make sense to penalize people because of a decision which they did not control.

CHANGES IN EMPLOYER DEDUCTION RULES FOR QUALIFIED PLANS - PROFIT-SHARING OR STOCK BONUS PLANS

Under current law, employer deductions for contributions to profit-sharing or stock bonus plans are limited to 15% of aggregate compensation paid to covered employees during that year with a carry forward to a succeeding year of up to 25%.

The Administration proposes to repeal the 15% of aggregate compensation limit and, in its place, limit the contribution to such plans for any individual to 15% of the individual's compensation for the year. Contributions made in excess of the individual 15% limit could be carried forward and deducted in the succeeding year subject to the individual 15% limit for that year. If less than 15% of an individual's compensation were contributed, the unused limit could not be carried forward unless the individual's plan is a "retirement type" plan. A profit-sharing plan would be treated as a "retirement type" plan with respect to an individual in any year if the individual is an active participant in the plan and

- o does not participate in any other qualified profit-sharing or stock bonus plan sponsored by the employer;
- o contributions are made or allocated according to years of service;

- no distributions or loans are available before separation from service, death, or disability; and
- the plan is not top-heavy.

The current 15% aggregate deduction limit should be maintained. Profit-sharing plans and stock bonus plans allow an employer to share profits with employees on a retirement savings basis. There is no precedent or rational policy justification for instituting the 15% individual deduction limit on top of the already applicable Section 415 limitations. Apparently, the Administration simply desires to severely restrict profit-sharing and stock bonus plans.

The proposal, if adopted, would preclude employer flexibility in weighting allocations for longer-service employees. It would effectively reduce retirement savings for many lower-paid participants in plans where contributions are based on seniority. Additionally, it appears that the proposal directly precludes integration with Social Security where the employer wants to put in a maximum contribution. These are significant problems in fashioning a meaningful employee benefit for both the sponsoring employer and employee.

EMPLOYER DEDUCTION LIMITS FOR ALL COMBINATIONS OF DEFINED CONTRIBUTION AND DEFINED BENEFIT PLANS

At present, if an employer maintains both a pension plan and a profit-sharing or stock bonus plan, total deductible contributions are limited to the greater of 25% of the aggregate compensation paid during the year to employees covered by the plans, or the amount necessary to meet the minimum funding standard for the pension plan. It is important to note that the Internal Revenue Code makes the technical distinction between "pension" plans and Section 401 qualified plans that are not "pension" plans, i.e., profit-sharing and stock bonus. Thus, contributions to a defined benefit pension plan and a money purchase pension plan are not subject to the 25% of aggregate compensation limit.

The Administration's proposal extends the 25% of aggregate compensation limit to combinations of defined benefit plans and money purchase plans. Thus, regardless of the type of plans maintained by the employer, the corporate deduction would be limited to the greater of 25% of aggregate compensation for covered employees or the amount necessary to meet the minimum funding standard for the defined benefit plan.

The Administration's proposal would negatively impact many small employers' plans. In closely held corporations where a defined benefit plan is in place providing benefits to longer-service older employees, it would be impossible for the employer to implement a meaningful retirement benefit (a money purchase plan) for the younger and shorter-service employees as a result of this proposed limitation. A major goal of retirement policy is to increase coverage for younger, shorter-service employees. This proposal would frustrate that effort. Current law correctly provides for a more favorable deduction rule when a money purchase plan is combined with a defined benefit plan. A money purchase plan involves a binding legal commitment to make specified annual employer contributions to a retirement plan subject to minimum funding standard requirements. A profit-sharing plan, on the other hand, includes no such commitment by an employer. The current deduction rules encourage employers to adopt money purchase plans rather than profit-sharing plans.

PROPOSED MODIFICATION OF SECTION 403(b) PROVISIONS

Section 403(b) permits employees of certain tax-exempt and state or local educational organizations to defer the receipt of cash compensation and to have their employer contribute the deferred amount to an annuity contract or custodial account. Generally, income tax on such deferred amounts and on income earned by them is not payable until the employee receives a distribution of benefits from the annuity or custodial account.

The Administration's proposal would repeal certain special flexible contribution limits that currently apply only to

Section 403(b) annuities and custodial accounts. Moreover, it would prohibit distributions from Section 403(b) annuities except upon separation from service, attainment of age 59 1/2, death or disability, and thus would apply distribution rules to Section 403(b) plans that are more restrictive than the distribution rules applicable to most qualified plans.

The proposal would also prohibit application of the doctrine of constructive receipt to Section 403(b) annuities and custodial accounts. The doctrine of constructive receipt is a tax rule which the Internal Revenue Service currently applies to Section 403(b) annuity plans, but not to other qualified plans.

Unlike most qualified pension and profit-sharing plans, which are funded primarily with employer contributions, many Section 403(b) plans are funded by employee contributions made through an annual reduction in salary. Under this arrangement, therefore, the employee and not the employer is primarily responsible for funding retirement income.

Since the enactment of the Employee Retirement Income Security Act of 1974 ("ERISA"), Congress has recognized that the level of salary reduction contributions that an employee of a tax-exempt organization or public school can afford early in his career may be significantly lower than the contributions he can afford in later years. An employee's initial lack of resources may prevent him from funding his 403(b) plan in an adequate and timely manner.

The special limits, frequently referred to as "catch-up limits," are set forth in Code Section 415(c)(4). They are available to employees of educational organizations, hospitals, home health service agencies, and churches. Under Section 415(c)(4), an eligible employee may contribute to his Section 403(b) annuity or custodial account an amount which may exceed the contribution otherwise allowable under the general Section 415 limit, if it is necessary to allow him to "catch up" for years in which he did not make his allowable contribution.

As recently as 1982, when it enacted the Tax Equity and Fiscal Responsibility Act ("TEFRA"), Congress had occasion to reconsider and affirm the Section 415(c)(4) catch-up provisions. At that time, TEFRA extended the benefits of those provisions to church employees, a group whose Section 403(b) contributions were previously governed by the general Section 415 limit only.

The limits on Section 403(b) contributions under current law are no more generous and often less generous than the limits applicable to other retirement plans. The employee who utilizes the catch-up provisions is not obtaining tax benefits larger or sooner than one who contributes the maximum from the beginning of his career. All these provisions do is provide important flexibility. Accordingly, preservation of the existing limits on Section 403(b) contributions, including the catch-up limits, is appropriate. The need for flexible Section 403(b) contributions, which Congress has reaffirmed since 1974, still exists.

The rules governing distributions from Section 403(b) plans should not be more onerous than the rules governing distributions from qualified pension and profit-sharing plans. One of the principal stated goals of the Administration's proposal is to unify the rules governing benefit distributions from qualified plans. Despite this goal, the proposal would prohibit any distribution of benefits from a Section 403(b) annuity or custodial account before the occurrence of one of the following events: separation from service; death; disability; or the attainment of age 59 1/2. The distribution rules that would apply to most other qualified plans, on the other hand, do not require the occurrence of a specific event to permit a benefit distribution.

The proposed restrictions will have the counterproductive effect of discouraging retirement savings by participants in Section 403(b) programs. The overwhelming majority of Section 403(b) participants are middle-income wage earners, the largest group of which are public school teachers. While these employees use Section 403(b) annuities for retirement purposes, their willingness to do so is materially affected by the fact that amounts are accessible prior to retirement. If that accessibility is eliminated, there is a high likelihood that many of these employees will cease to participate. Whereas restrictions and penalties on withdrawals have relatively little importance to upper-income employees, they act as a powerful deterrent against retirement savings by the lower-paid.

Conclusion

We recognize the Congress' task in developing a tax reform bill is not an easy one. We do not take our positions lightly, and are firmly convinced that taxing employee benefits is not in the best interest of workers, their families and the country. Our current system of encouraging employer-provided coverages has worked remarkably well. Coverage is widespread; it is provided through an efficient, effective, flexible group mechanism; and it has relieved government of the responsibility.

The specific proposals advanced by the Administration are inconsistent with our country's long-established policy favoring employee benefits, and we urge your Committee to reject them. To impose any tax on employee benefits would establish a bad precedent and could signal to employers and employees that the proposed taxes are only the first step.

We urge Congress to continue the present system of tax incentives so that our employee benefit programs remain intact.

We appreciate having the opportunity to make this statement. We would be happy to attempt to furnish any additional information which the Committee might think helpful.

Written Comments for the Record
of
Patricia Crane Ramsay
President
Of The
American Dental Hygienists' Association

Senate Finance Committee
Hearings on The President's Tax Proposals

July 19, 1985

Mr. Chairman: Thank you for this opportunity to testify on the President's Tax Proposals, particularly those recommendations that pertain to fringe benefit taxation. I am Patricia Crane Ramsay of Boston, Massachusetts, a registered dental hygienist and currently President of the American Dental Hygienists' Association.

ADHA represents approximately 30,000 dental hygienists who are specialists in the delivery of preventive dental care. The majority of the members of the Association practice dental hygiene in offices of private practice dentists but an increasing number practice in institutional settings which include nursing homes, long-term care facilities for the aging, special care facilities for the disabled and handicapped, correctional institutions, hospital dental clinics, dental hygiene and dental schools, community health centers, etc. As preventive oral health specialists, the role of dental hygienists is expanding substantially in reducing the incidence of dental caries and preventing the onset of periodontal disease.

In addition to the expanding knowledge and broadened reach of the dental team--dentists, hygienists and dental assistants--a major force in the reduction and treatment of dental diseases has been the unique status and enormous incentives that have been granted by Congress to so-called "fringe benefits" through the tax code. For the past 40 years, health care benefits have been the central part of these fringe benefits, which are negotiated between labor unions and industry and incorporated in bargaining agreements in every sector of our economy. Beginning in 1954, dental prepayment insurance was included in an agreement between the international longshoremen's and warehousemen's Union-Pacific Maritime Association and the West Coast shipping industry. The pre-payment of dental services both preventive and restorative, has been a fact of life for three decades and has led to a life-style that regards dental health as ranking in importance with general health and well-being. More than one-third of the nation's population has employer-paid dental insurance for employees and their families.

Cost of dental care and dental insurance is, without question, considerable. The Health Care Financing Administration has just reported that total spending for dental care in 1984 should reach $23.7 billion. Only $1 billion of this amount represents federal, state and local government funds. Patients' out-of-pocket expenses totaled $15.8 billion and private dental insurance accounted for $6.9 billion. Expenses for dental care are expected to increase to approximately $31 billion in 1987 and $39 billion in 1990. The proportion of this total generated through employer-paid private dental insurance can be expected to increase, with such increases continuing through this decade. It appears possible that employer-paid dental insurance could account for up to $10 billion of the estimated $39 billion dental expenditures in 1990.

It is very significant however, that only $1 billion out of $23.7 billion--4.2%--comes as a direct outlay of the government. Patients themselves spent $15.8 billion of this total, while dental benefit plans pay nearly $7 billion. We therefore see a health benefit system with relatively low direct involvement by government, counterbalanced by historically strong participation by the private sector.

The economic dynamics of dental health care are a major factor in limiting federal/state involvement and at the same time minimizing costs. First, most dental health insurance plans are negotiated under the collective bargaining system between labor and management. There is a healthy tension between the interests of quality dental care and costs of each plan. The result of this tension has been a strong trend towards co-payment, which has helped keep the cost of insurance down yet encouraged employees to take care of their dental health needs. A second feature that has also helped deflate costs has been the emphasis on prevention. Dental insurance rewards patients who take care of their teeth in order to avoid oral disease which would require expensive restorative care.

Major dental benefit plans, in most instances, cover 100 percent of the cost of diagnostic and preventive treatment, which includes routine oral examinations, prophylaxis, fluoride treatment, pit and fissure sealant applications, x-rays, tooth charting and periodontic charting. All of these procedures, performed generally by dental hygienists in most dental offices, are preventive oral health measures intended to help patients avoid dental disease, such as dental caries and periodontia.

The American Dental Hygienists' Association has therefore been a strong and unapologetic supporter of our present system of using the tax code to provide incentives for owning dental insurance. We understand that this nation faces huge and unrelenting federal deficits and know that the instincts of some to attack fringe benefits en bloc are motivated by an intent to produce revenue. To some degree that will be the nature of your process also, despite Congress' and the President's present goal of revenue neutrality. You will be asked instead to trade away the revenue that can be gained from the taxation of dental benefits in order to help fund restoration of other benefits for business that were eliminated by the President's proposal--investment tax credits, tax-exempt bonds, depreciation, etc. ADHA urges you to resist this temptation and to review dental benefits on their merits: their social value measured against their cost and their proven effectiveness compared to that of any replacement.

Our view of the President's proposal--taxing the first $10 a month paid by employers for individual health benefit plans, and the $25 a month for families--is one of strong opposition. It is just as regressive as its predecessor in Treasury I, the "tax cap". Under this proposal, everyone who pays taxes will pay taxes on these benefits. This will have special consequences for those least able to afford those costs--low and middle income working people. Unlike the "tax cap", the consequences on dental benefits will be less immediate and less direct. As the taxable floor for a family rises above $300 in future years, it will force taxpayers to make choices between catastrophic and prevention-oriented insurance, at great cost to dental insurance. And because it is regressive, this will also have the effect of squeezing lower bracket taxpayers more and more over time, forcing these choices about a family's health care budget to be made earlier than similar decisions by those of greater affluence. Even as it stands now, this phenomenon will take its toll. In the end, this proposal will have the effect of gradually stripping low and middle income people of their health care protection--starting with the preventive and therefore most cost-effective forms of insurance.

Nor, as you can surmise, did we like the "tax cap" any better. Premised on the notion that it would put downward pressure on insurance costs, it would instead force families to lop off insurance policies in their portfolio when the total premiums exceeded a certain ceiling--again starting with the least catastrophic and most preventive. The tax cap was equally regressive in that lower-income taxpayers would have been less able to afford health costs above that ceiling and more prone to forced reduction of their health care protections.

Dental insurance and therefore dental care has greatly benefited from the present favorable treatment granted fringe benefits. It has been able to withstand the periodic scrutiny that has been directed (and deservedly so) at the tax-exempt status of all fringe benefits. Congress has reviewed each critically, eliminating some, modifying others and retaining the rest. Health insurance has thus far withstood that test and, we believe, will continue to do so. Dental insurance has proven its worth over time--from a cost and an effectiveness point of view. ADHA urges the Committee to reject the President's proposal for taxing these benefits.

WRITTEN STATEMENT OF JAMES ALBERTINE, DIRECTOR OF GOVERNMENT AFFAIRS OF THE AMERICAN SOCIETY OF ASSOCIATION EXECUTIVES

The American Society of Association Executives ("ASAE") is pleased to have the opportunity to present a written statement for the printed record of the July 19, 1985 hearing of the Committee on Finance, U.S. Senate on "the projected impact the tax plan will have on employee benefit programs" announced in Press Release No. 85-048 issued on June 25, 1985.

ASAE is headquartered at 1575 Eye Street, N.W., Washington, D.C. 20005 (202-626-2703) and is the professional society for executives who manage trade and professional associations as well as other not-for-profit voluntary organizations in the United States and abroad. Founded in 1920 as the American Trade Association Executives with 67 charter members, ASAE now has a membership of over 12,000 individuals representing more than 6,500 national, state, and local associations. In turn, these business, professional, educational, technical and industrial associations represent an underlying force of more than 55 million people throughout the world. The overwhelming majority of ASAE's members represent tax-exempt organizations, most of which are either tax exempt as trade associations under Section 501(c)(6) of the Internal Revenue Code ("Code") or tax exempt as educational or charitable organizations under Section 501(c)(3) of the Code. Many of ASAE's member associations either sponsor or are contemplating sponsoring cash or deferred arrangements ("CODA's") also known as 401(k) plans, or unfunded non-qualified deferred compensation plans or both. As a result, ASAE is an interested party to legislative activity in these areas.

"The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity" ("President's Proposal") contains three provisions regarding retirement plans that uniquely apply to private sector tax-exempt organizations and public sector employers. First, the President proposes that private sector tax-exempt organizations and public sector employers no longer be permitted to establish and maintain CODA's. Second, the President proposes to establish a set of rules for unfunded non-qualified deferred compensation arrangements of private sector tax-exempt organizations that would be similar to the rules applicable to public sector employers. Those rules for public sector employers are currently contained in Section 457 of the Internal Revenue Code ("Code"). Arrangements conforming to these rules appear to be the exclusive method for providing nonqualified deferred compensation arrangements for private sector tax-exempt employers. Third, the President proposes to eliminate the special limits on maximum contributions to tax-sheltered annuities for employees of certain tax-exempt organizations participating in tax-sheltered annuities. The combined impact of these three proposals would be to reduce the ability of an employee of a private sector tax-exempt organization to save for his or her retirement on a tax-favored basis.

ASAE's written comments will be directed only at the proposals regarding CODA's and non-qualified deferred compensation arrangements. However, ASAE strongly supports permitting private sector employees to continue to save their earnings through tax favored programs designed to provide income security during retirement. Therefore it generally opposes any changes in the current tax-sheltered annuity (403(b) annuity) rules that would jeopardize the retirement security of employees who may participate in these arrangements.

401(k) PLANS

Chapter 14.06, "Revise Cash or Deferred Arrangement (Section 401(k)) of the President's Proposal proposes that 401(k) plans be made available only to taxable employers. Tax-exempt and public sector employers would be precluded from maintaining 401(k) plans.

In the explanation of reasons for change, the President's Proposal is in error when it states that private sector tax-exempt employers may offer their employees tax-sheltered annuities. This is only true for private sector tax-exempt employers exempt from taxation under Code Section 501(c)(3). Trade associations and professional societies exempt from taxation under Code Section 501(c)(6) and other private sector employers generally not subject to taxation do not have access to 403(b) plans.

The President's proposal to eliminate tax-exempt organizations access to 401(k) plans also appears to assume that 401(k) plans and unfunded deferred compensation plans ("457 plans") are equivalent vehicles for retirement savings. This premise is inaccurate for the reasons to be discussed later in this written statement. The primary reason is that an unfunded arrangement in the private sector does not offer adequate retirement income security.

At one time it was unclear whether a tax-exempt organization could maintain a profit sharing plan. In 1983 the Internal Revenue Service ("IRS") released General Counsel Memorandum ("GCM") 38283 dated February 15, 1980, that said that an employer exempt from taxation may have a profit sharing plan. This GCM adopted an economic concept of profits that defined profits as the excess of receipts over expenses. ASAE believes the analysis in this GCM is correct and that private sector tax-exempt employers should be permitted to continue to provide 401(k) plans to their employees, either as profit sharing plans or money purchase pension plans. ASAE understands that the revenue impact of permitting private sector tax-exempt employers to continue to maintain 401(k) plans for their employees is minimal.

NON-QUALIFIED DEFERRED COMPENSATION PLANS

Chapter 14.10, "Unify Rules for Unfunded Deferred Compensation Arrangements of States and Tax-Exempt Employers" of the President's Proposal proposes that unfunded non-qualified deferred compensation arrangements presently made available to public sector employers under Code Section 457 be made available to private sector tax-exempt organizations. Under the current rules contained in Section 457, a participant may defer each year the lesser of $7,500 or 33 1/3% of his annual compensation. In some ways, 457 plans are comparable to the proposed restructered 401(k) plans and would allow greater percentage deferrals than the proposed restructured 401(k) plans. However, there are two problems with the President's Proposal that would jeopardize the retirement security of an employee of a private sector tax-exempt organization and under current law would restrict participation in these plans to highly compensated employees or a select group of management employees.

The first problem is that the amounts deferred would be unfunded. Therefore, these amounts would be subjett to the general creditors of the private sector tax-exempt employer rather than being set aside in an arrangement that would be safe from the general creditors of the employer. This defect greatly reduces the retirement security of an employee because of the uncertainty whether his employer will be financially able to satisfy its obligations. This concern for fiscal well-being is enhanced because private sector tax-exempt organizations, unlike public sector government entities, do not have the ability to levy taxes to raise revenue. If this program is adopted in lieu of 401(k) plans, employees of private sector tax-exempt employers would not be treated equally with employees of for-profit employers.

The second problem appears to be that 457 plans of private sector employers are not excluded from the provisions of the Employee Retirement Income Security Act of 1974 ("ERISA") administered by the U.S. Department of Labor. These ERISA provisions would require 457 plans maintained by private sector employers to be funded if they were made available to employees who were not highly compensated or a member of a select group of management. The drafters of ERISA were concerned that most employees did not have the information about the employer or the bargaining position with the employer to be subjected to the financial risk of unfunded deferred compensation. Unless a specific exemption from the application of Title I of ERISA is provided, as a practical matter, plan participation may need to be limited to highly compensated employees or a select group of management employees, thereby creating an additional disparity between public and private sector employees.

The President's Proposal appears to be a continuation of the controversy started in 1978 when the Treasury Department issued proposed Treasury Regulation §1.61-16 that appeared to override the constructive receipt rules surrounding non-qualified deferred compensation that had developed since at least 1960. Congress, in 1978, restored the status quo to "for profit" employers and created a new status quo for public sector employers and rural electric cooperatives by establishing 457 plans. However, Congress left private sector tax-exempt employers in a state of limbo.

The President's Proposal appears to permit the continuation of certain executive unfunded non-qualified deferred compensation arrangements if such arrangements were negotiated as part of a binding contract and did not permit periodic deferral elections. The proposal states, "The rules permitting the elective deferral of compensation by employees of States on a non-qualified and unfunded basis would be expanded to apply to the employees of employers exempt from tax under the Internal Revenue Code" [emphasis added]. One would think that this proposal would apply only to those unfunded non-qualified deferred compensation arrangements where employees can periodically in advance elect on a purely elective basis to defer compensation. However, the proposal does not contain any description of what is meant by "elective deferral of compensation". It is difficult to determine from reading the President's Proposal whether this proposal is meant to be the exclusive test for taxation of unfunded non-qualified deferred compensation that does not meet the requirements of the President's Proposal.

ASAE's members are particularly sensitive to the tax incentives for employer-provided fringe benefits such as non-qualified deferred compensation because these incentives affect their ability to attract well-qualified personnel. Industry and associations frequently compete within the same labor pool for individuals who have developed the necessary technical expertise and sensitivity from the industry the association represents. These individuals may come from an employer large enough to afford a comprehensive benefit package even in the absence of tax incentives. That is, certain large employers have the financial resources to compensate employees without concern for income taxation because they can afford to compensate the employee for adverse income tax consequences by increasing the level of compensation.

Because most associations that are members of ASAE are tax exempt and many are small employers, they are concerned about tax incentives that favor for-profit or large employers or create tax disadvantages for tax-exempt or small employers because they create an often insurmountable handicap in attracting highly skilled employees. It would be ironic if Congress would pass a statute that would increase the operating costs for tax-exempt employers after having determined that the type of operation met a social purpose that deserved a tax exemption. The importance of employer-provided fringe benefits, such as unfunded non-qualified deferred compensation to potential employees, particularly those looking to change jobs after acquiring family responsibilities, should not be underestimated.

ASAE strongly urges Congress to adopt the same position for tax-exempt employers regarding non-qualified deferred compensation that it approved in 1978 for "for-profit" employers. As a representative of the employees of tax-exempt associations, ASAE is most concerned with the tax incentives that provide tax-preferred status at the employee level. ASAE believes that private sector tax-exempt associations need the flexibility that unfunded nonqualified deferred compensation arrangements provide an employer in designing adequate retirement income security for executive level employees. These employees are often recruited from other employers late in their careers and often lose substantial retirement income when they move to a new employer at that point in their careers.

CONCLUSION

The President's Proposal challenges Congress to better define the ability of tax-exempt organizations to provide retirement income to their employees in a tax-favored manner. It appears that the proposal attempts to reduce the loss of revenue from retirement savings and to strengthen the constructive receipt rules for taxation. ASAE proposes that Congress permit private sector tax-exempt employers to continue to maintain 401(k) plans (either as profit sharing plans or money purchase pension plans) and to maintain unfunded non-qualified deferred compensation arrangements that are tailored to the employee's needs on a tax-deferred basis. ASAE believes Congress should adopt ASAE's proposals. These proposals would not materially affect the revenue expenditure for retirement savings or frustrate the Administration's attempts to strengthen the constructive receipt rules for taxation.

The text of the President's Proposal and the statements of Administration officials have emphasized the social and philosophical underpinnings of proposed tax reform. Fairness, simplicity and encouragement of personal savings are primary among these underpinnings. ASAE strongly believes that the use of these sensible and flexible arrangements for encouraging retirement savings for the broadest possible number of American workers should be encouraged further rather than discouraged. In this context, the proposal to eliminate access to 401(k) plans for employees of private sector tax-exempt organizations and the proposal on unfunded non-qualified deferred compensation arrangements for private sector tax-exempt employers are particularly ill-advised. Under the proposals, the retirement income security of employees of private sector tax-exempt organizations would be inferior to that of employees of taxable organizations. This would increase the difficulty for private sector tax-exempt organizations to attract and keep talented employees, particularly at the executive level. These significant differences in the retirement savings protection for employees of taxable and tax-exempt organizations are not only inequitable, but also defeat the Administration's stated goal of encouraging retirement savings. In short, ASAE believes that employees of private sector tax-exempt organizations should be treated as favorably as employees of other organizations.

ASAE is pleased to be a part of the ongoing dialogue concerning the role of the tax laws in the employee benefit area. ASAE represents a large, well-informed constituency that is extremely interested in this and other employee benefit issues. ASAE welcomes the opportunity to assist the Congress by providing the much needed information it needs to analyze the effectiveness of the current tax law and to consider the need for future changes. ASAE is available to collect and provide you with the information you need to make informed well-reasoned decisions concerning private sector tax-exempt associations. ASAE will continue to communicate with its membership to advise it of the status of Congress' deliberations on this and other issues of interest.

TESTIMONY OF THE AMERICAN SOCIETY OF PENSION ACTUARIES TO THE SENATE FINANCE COMMMITTEE RELATIVE TO IMPACT ON EMPLOYEE BENEFIT PLANS OF THE PRESIDENT'S TAX PROPOSALS TO THE CONGRESS

I. STABILITY OF THE PRIVATE EMPLOYEE BENEFIT SYSTEM

ASPA is gravely concerned over the pace of legislative activity affecting employee benefits. Starting in 1981, we have seen four major acts, each with profound impact on employee benefit plans: ERTA in 1981, TEFRA in 1982 and DEFRA and REA in 1984.

Now we face another massive change with the President's Proposals.

But the worst part is that still more changes are waiting in the wings. These include social security integration, vesting, defined benefit asset reversion, and single employer plan termination insurance.

We face all of this at a time when we are still reeling from the effects of TEFRA, DEFRA and REA.

If anyone wanted to destroy the private system, and place the entire burden on social security, this might be the way to do it.

ASPA is convinced that deficit reduction pressures will interact with social justice pressures in maintaining the pace of activity at its current level. We do not believe this pace can be slowed.

However, there is an alternative which appears both feasible and effective. This alternative is quinquennial implementation.

With quinquennial implementation, employee benefit legislation could be enacted as frequently as necessary. But all legislation enacted in any five-year period would become effective one year after the end of the period. This rule would apply to all legislation requiring changes in plan design or administrative systems.

The Retirement Equity Act is effective in 1985. Hence, the next quinquennial implementation year might be 1990. All legislation enacted from 1985 through 1988 would be implemented in 1990. All legislation enacted from 1989 through 1993 would be implemented in 1995, and so forth.

Quinquennial implementation would end the need for continual plan amendment, employee reorientation and computer system redesign. It would mean that money now being spent on these efforts could be spent where it should be: to provide employee benefits.

Quinquennial implementation would not itself require enactment of any new law. It would simply require an agreement within Congress. This agreement would have to be clearly understood by the tax committees, the labor committees and their staffs.

ASPA recommends in the most vigorous terms possible that the Committee adopt the concept of quinquennial implementation now. We recommend that this approach be initiated with the employee benefit provisions of the President's Proposals.

II. DISCRIMINATION AGAINST SMALL BUSINESS

The appeal to self interest is the driving principle in the use of the tax code to encourage socially desirable employee benefit plans. The approach is to tell a firm's managers they can help themselves to favorable tax treatment only if they help their rank and file workers, too.

The approach has proven remarkably successful.

Unhappily, there is a growing bias among policymakers at Treasury and the Internal Revenue Service in favor of curtailing the effect of this approach in the case of smaller businesses. There appear to be two factors behind this bias. One, the inadequate return theory, is at least rational. The other, the greedy entrepreneur theory, is totally irrational, and unfortunately the more powerful of the two.

THE INADEQUATE RETURN

Tax favored treatment is often described as a "tax expenditure". Without the treatment in question, it would be possible either to lower tax rates in general, or to generate tax revenue for other purposes. Hence, the treatment means taxpayers in general are either paying extra taxes or foregoing other public expenditures.

If the tax favors helped only a firm's highly compensated employees, the tax expenditure would be viewed as undesirable. It is desirable only if it prompts the provision of benefits for rank and file workers. And, the price must be right. A certain amount of tax favoritism for highly compensated employees must buy at least a certain amount of coverage for rank and file employees.

Therein lies the rub.

Small firms have always had and will always have a higher ratio of chiefs to indians than the large ones. The extreme case is a solo entrepreneur. There are no indians at all. Almost as extreme is an entrepreneur with just one lower paid employee. Some policymakers feel these are firms where an expenditure for tax favored employee benefits is not justified.

THE GREEDY ENTREPRENEUR

Small entrepreneurs act out of self interest. So do the occupants of big business' executive suites. Our free enterprise system depends on it. The use of tax incentives to achieve social goals depends on it. Substitution of the word "greed" for the expression "self interest" is simply a resort to inflammatory pejoratives.

So, justification of discrimination against small business people because they are greedy is without rational basis. It overlooks the fact that all people are "greedy". It overlooks the fact the "greed" is what makes both free enterprise and our system of tax incentives workable.

"Greed" makes it important that there be controls surrounding all tax favors. It does not justify controls which discriminate against small businesses.

THE CASE AGAINST DISCRIMINATION

If one discards the greedy entrepreneur theory, just one question remains: do the arguments against discrimination outweigh the "inadequate return" argument? We believe they do. We see four important reasons why discrimination against small businesses should be vigorously avoided, in formulating and administering employee benefit rules. These are universal coverage, economic vitality, simplicity and fairness.

UNIVERSAL COVERAGE

Private employee benefit plans cannot play a meaningful role in our overall program of worker protection unless coverage is virtually universal. If any significant group of workers remains uncovered by private benefits, the pressure to do the job through public plans eventually proves overwhelming.

At present, there are private plan coverage gaps in each major area of protection: retirement, death, disability income and health care. In each case, there is a clear relationship between employer size and extent of coverage. The larger the firm, the greater the probability that its employees will have private protection. Statistics demonstrating this are readily available.

These statistics make it clear that virtually universal coverage requires significant improvements in the extent of coverage among small employers. The way to encourage employers to adopt and maintain plans is to strengthen incentives, not impose onerous burdens.

The consequence of onerous burdens is also demonstrable. TEFRA, enacted in 1982, reflects the greatest single instance of discrimination against small businesses in the history of legislation affecting employee benefits. I.R.S. statistics on new plan formation tell the story. In 1984, the first year TEFRA was fully effective, new retirement plan approvals dropped by 36%. Most observers believe this unprecedented reversal in trend is attributable almost entirely to TEFRA.

The consequence of an end to discrimination against small business will be increased private plan coverage. The consequence of increased private plan coverage will be reduced pressure to liberalize social security and related programs. Viewed in this light, the expenditure/return ratio is not unattractive. In fact, it becomes very attractive.

ECONOMIC VITALITY

The tax structure is just one factor a talented individual will examine, in considering the choice between entrepreneurship and the executive suite. But it is an important one. Employee benefit rules are just a small part of the tax structure. But they are material. They become particularly significant when the entrepreneur who has enjoyed a certain amount of success must decide whether to go on - or sell out.

To understand the chilling effect employee benefit rules can have on entrepreneurship, consider one aspect of the top-heavy plan rules added by TEFRA. Because of the way key employees are defined, it is possible for a firm to avoid top-heavy status by the simple act of selling out to a larger firm. The peculiar part is that the firms might have had identical retirement programs. They might decide to continue these programs after merger. Apart, one of them had a top-heavy plan. Together, neither does. Being top-heavy involves consequences which few large firms would willingly endure.

It would seem difficult for anyone to dispute the importance to our economy of maintaining a climate which encourages entrepreneurship. The problems which our established industries now face demonstrate how important it is that we develop new products and new services. Without a continuous flow of new industry, we shall find ourselves second class in the ranks of world citizens. As outsiders continue to challenge our established industries, we must continue to find new fields in which our superiority can be established.

Ownership interest is one of the most effective possible incentives to the development of new products and services. And entrepreneurship is the most complete form of ownership interest in existence.

Purely apart from the need for innovation, we need small business for the vitality it brings to our free market economy. As we permit our businesses to become bigger and bigger, and fewer and fewer, we find that the power of the free marketplace is muted by the bureaucratic structure of the large enterprise. We find administered prices. We find that wage rates are established either unilaterally, or by negotiation between a few large companies and a few large unions.

Some members of the Committee may question our use of this forum to discuss the importance of small business to our economy. The discussion should not have been necessary. However, this sense of importance seems to have been lost by the policymakers at Treasury responsible for legislative recommendations involving employee benefits. We feel certain it has not been lost by the Committee. We believe a reminder to the people at Treasury might be appropriate.

In assaying legislated tax discrimination against small business, it is worthwhile to remember the many items of inherent non-tax discrimination. Because a small business has fewer employees than a large one, its unit cost for professional advice is greater. It is unlikely to have in-house specialists. Its negotiating stance with insurance companies and investment managers is less attractive. These are all reasons why, if anything, one might justify tax discrimination in favor of small business.

SIMPLICITY

Simplicity is a key element of the President's Proposals. The desire for greater simplicity in our tax structure is one which is shared by every taxpaying citizen of this country. It is certainly one which is shared by every employee benefit plan sponsor and practitioner.

Even the most casual observer will recognize that the objective of simplicity is not fully realized in the President's Proposals. At certain points, the cause has suffered severe setbacks.

The correlation in the Proposals between complexity and discrimination against small business is notable. The greatest elements of complexity are associated either with new elements of discrimination or failure to eliminate existing ones.

Consider one flagrant example. In discussing limitations on benefits and contributions, the Proposals address the combined plan limit of IRC §415(e). They state that this limit "imposes a significant burden on employers and plans." They tell how the provision "requires an employer to maintain significant records for many employees and to coordinate the contributions and benefits under all of its tax-favored retirement plans." They state that "In most situations, the maintenance of both a defined contribution plan and a defined benefit plan would better serve the interests of employees generally."

Then, they recommend elimination of the noxious provision for all plans EXCEPT THOSE WHICH ARE TOP-HEAVY. As anyone active in the field knows, it is very difficult for smaller employers to have plans which are not top-heavy.

Nowhere is it explained why the small employer should have to suffer the "significant burden" from which the large employer is to be relieved. Nowhere is it explained why maintenance of both types of plan would not "better serve the interests of employees" of small employers as well as employees of large ones.

We have already pointed out the greater per-employee recordkeeping cost which a small firm must endure because of its size. To further unbalance the scales with this discriminatory approach to §415(e) is unconscionable.

We believe that as the Committee reviews our detailed recommendations, they will recognize additional instances where discrimination against small business has gone hand in hand with complexity.

Complexity is a powerful disincentive to new plan formation.

FAIRNESS

Suppose avoidance of discrimination could not be justified on the basis that avoidance helps promote universal coverage. Suppose it could not be justified on the basis that encouraging entrepreneurship helps maintain a vital economy. Suppose it could not be justified on the grounds of simplicity.

Suppose it were concluded, in short, that a tax expenditure/reward analysis does not justify tax favors for small businesses.

THERE WOULD STILL BE THE QUESTION OF FAIRNESS.

Under current law, for example, we tell the executive of a large company that his retirement benefits and allocations may be based on his full $300,000 salary. We tell the small entrepreneur earning the same salary that his covered pay for retirement plan purpose will be stopped out at $200,000. Is this fair?

The question takes on particular meaning when one considers that the large company has alternative and relatively painless methods for providing deferred compensation. Some of these alternatives are either unavailable or painful in the case of the small firm.

We are not suggesting, here, that it is either proper or improper to stop covered compensation at $200,000. We do suggest that in the interest of fairness, whatever rule applies should apply to all employees of all employers.

We might justify fairness on the basis of its importance as an integral part of the President's Proposals. The very word is part of the title.

We might justify fairness on the basis that fairness is the American way of doing things. Indeed, it is an important part of our society's morality.

We justify fairness on both of these grounds. But there is a third factor. Effective enforcement of a tax code in a free society is possible only if it is perceived as fair by the taxpayers.

This has often been pointed out. In fact, it is one of the tenets underlying the President's Proposals. But when this principle is articulated, the taxpayer in mind is usually the man in the street - the average citizen.

Very few observers realize how important it is that the small businessman perceive the code as fair. In the highly complex area of small business tax administration, voluntary compliance grounded on a perception of fairness becomes critical.

ASPA RECOMMENDATIONS TO ELIMINATE DISCRIMINATION

We urge the Committee to consider these amendments to the President's Proposals. Some are changes, some are additions, some are deletions. We make these recommendations in the interest of eliminating discrimination against small employers:

LIMITATIONS ON BENEFITS AND CONTRIBUTIONS

> The Proposals call for a 10% excise tax on distributions which exceed $112,500 per year for any individual. The dollar amount

is to be indexed starting in 1988. We commend this proposal as a means of accomplishing all of what §415 was designed to accomplish - and more.

But, the Proposals do not go far enough. Having offered this simplification, they should have proposed eliminating all of §415, not just §415(e). Perhaps the 10% rate is too low. Perhaps the $112,500 amount is too low. Indeed, we believe it might more sensibly be initialized at $150,000.

The point is that the proposal is a simple and effective way to control excessive qualified plan funding - there is no incentive to fund a benefit which is going to be subject to a stiff excise tax. It is a simple and effective way to control undue postponement of benefit commencement date. Extreme postponement simply means more of the benefit is subject to the tax.

Having established this simple control, we should eliminate the controls no longer needed - completely.

If the Committee should conclude that eliminating all of §415 is not desirable, the element of discrimination surrounding §415(e) should certainly be avoided. Either §415(e) should be eliminated for all plans or it should be retained for all plans. And the discrimination of current law should be repealed. Under this existing discriminatory provision, §415(e) is more restrictive for some top-heavy plans than for non top-heavy plans in general.

We recommend phased, but complete repeal of §415. In the meantime, we recommend immediate repeal of §415(e) for all plans.

The Proposals include a more restrictive approach to the §415 dollar limitation applicable to defined benefit plans. The proposal is that the full dollar limit be reduced for fewer than ten years of participation rather than ten years of service.

This proposal reflects bias against small entrepreneurs. It also reflects a total lack of understanding of the problems faced by new start-up businesses. There is reference to a need to prevent "the key employee of an employer, typically a small employer, from delaying the establishment of a defined benefit plan until such employee is close to retirement."

Small business formation is not always a smooth and orderly thing. It often ends in bankruptcy. When it is successful, it often involves several years of near failure and then, finally, dramatic success.

That knave who the Treasury policymakers believe has been craftily doing his employees out of pensions probably hadn't even been thinking about pensions. He was probably too concerned with meeting tomorrow's payroll.

As part of our effort to encourage the formation of new business entities, we must appreciate and work with this famine-and-then-feast pattern. We must maintain a tax structure which acknowledges existence of the pattern.

If it is not determined that §415 should be repealed completely, the approach to the defined benefit dollar maximum should be retained in its current form.

We recommend that the proposal to count participation rather than service be rejected.

RETIREMENT PLAN DEDUCTION LIMITATIONS

The Proposals would amend the 25% combined plan deduction limitations of §404(a)(7). At present, the limitations apply only to combinations involving profit sharing plans. The proposed application would involve all defined-benefit/defined-contribution combinations.

On the surface, this proposal appears innocuous. After all, defined contribution pension plans have a great deal in common with profit sharing plans. Actually, this proposal reflects the same objectives as the proposal to change the basis for applying certain §415 limits from service to participation.

That objective is to clip the wings of the entrepreneur who does not establish a retirement program until late in his career. Again, there is a lack of understanding of the famine-and-then-feast pattern of new business start-up.

We recommend that the 25% limitation of §404(a)(7) be entirely repealed. The limitations on contributions and benefits (§415 or its successor) provide all the controls needed.

The uninitiated observer might wonder why so much fuss is being made over a limit as high as 25%. For the individual fairly close to retirement age when a new plan is made effective, it is not difficult to exceed this limit. This is the case even with a plan providing modest benefits. We would be happy to furnish the Committee with numerical illustrations, if desired.

DISCRIMINATION AGAINST RANK AND FILE EMPLOYEES

ASPA applauds the concept of a bright-line coverage discrimination test.

However, the definition of the prohibited group involves elements of discrimination against small business. First, it automatically includes (for practical purposes) the highest paid three employees of the employer. Clearly, this is an inconsequential inclusion for a large company. It is not necessarily inconsequential for a smaller group.

Second, the definition includes 1% owners. An individual might own, say, $100,000 in a large company and still avoid 1% ownership. The answer is different for the person with a $100,000 interest in a small start-up enterprise.

We recommend that the highest-paid-3 category be removed from the prohibited group definition. We recommend, as well that consideration be given to elimination of the 1% owner category. The top 10% category appears to provide all the control that is needed. This is another case where simplification and the elimination of bias go hand in hand.

A number of benefit forms involve a proposed "concentration test." This is a carryover from current law. It applies to legal service, cafeteria, educational assistance and dependent care plans. Under the Proposals, it may be intended that the concentration test is to apply to all non-insurance-type fringe benefits.

Under the proposed new concentration test, one examines the highest paid 20 members of the prohibited group. If costs or benefits for these highest paid 20 exceed 25% of costs or benefits for all participants, the test is flunked and the plan is discriminatory. By looking at an absolute number, 20, the test discriminates blatantly against small enterprises. This biased test, like many other elements of bias, involves a high degree of complexity.

We recommend that all use of the concentration test be abandoned.

We have already referred to the $200,000 limitation on compensation applicable to participants in top-heavy plans. The President's Proposals make no reference to this limitation.

We recommend that the $200,000 limitation be addressed in any comprehensive tax reform package. Either it should be extended to all plans or it should be repealed.

RETIREMENT PLAN BENEFIT DISTRIBUTION RULES

The Proposals are laudable in suggesting elimination of bias respecting premature distributions.

However, they are silent on the bias under current law respecting required distributions.

At present, a 5% owner must commence receipt of benefits upon attainment of age 70½, whether or not he has retired. This requirement should apply to everyone, or no one.

We recommend that in view of the proposed excise tax on excessive annual distributions, a fixed mandatory starting age be viewed as unnecessary. Should the Committee feel retention of some maximum age is desirable, we are prepared with alternative suggestions.

EMPLOYEE STOCK OWNERSHIP TRUSTS

The President's Proposals are commendable in their general treatment of leveraged ESOP's. ASPA, too, believes that employee stock ownership is desirable, but should not be mixed into retirement security.

But here, again, there is bias against small business. The proposed new vehicle is to be available only to firms with at least 15 employees.

We recommend that this 15 employee restriction be rejected.

VESTING AND INTEGRATION

The provisions of §416 discriminate against small employers respecting vesting requirements and social security integration. In both cases, the discrimination is accomplished by imposing special rules on top-heavy plans. We have already remarked on the fact that most small employers find they are unable to escape top-heavy status.

The special social security integration requirements take the form of minimum benefit rules.

In both of these areas, the special rules were established with the objective of controlling perceived "greed" on the part of the small employers.

Vesting and integration are both areas where the only rational approach is to start with a definition of national objectives. Once the objectives are defined, sensible rule-making becomes possible. When the problem is approached in this way, the need for rules which are consistent for all plans becomes vividly apparent. A worker's needs are not affected by whether he works for a small company or a large one.

ASPA has a legislative outline in which we discuss both vesting and social security integration. Our proposed approach to social security integration, in particular, is developed in some detail. We would be pleased to make this outline available to the Committee.

For the moment, we believe the consensus will be that vesting and integration should not be addressed during the Committee's review of the President's Proposals.

III. OTHER AREAS OF CONCERN

ASPA has identified other areas where we believe the President's Proposals would benefit by amendment. We urge the Committee to consider each of these other recommendations:

DISCRIMINATION AGAINST RANK AND FILE EMPLOYEES

In applying the Proposal's 125% coverage test, an employee who fails to make a mandatory employee contribution is treated as not covered. However, if the contribution is converted to a cafeteria plan salary reduction, the same employee is treated as covered. We recommend that an employee who failed to make a mandatory employee contribution nevertheless be treated as covered. We make this recommendation for both retirement and welfare plans.

In applying the 125% coverage test to a retirement plan, it is proposed that, in certain cases, employees with fewer than two years be excludable. This is the proposal articulated for plans, other than cash/deferred arrangements, which provide full and immediate vesting. The two year exclusion is inconsistent with the three year eligibility rule of §410. The three year rule has been useful in helping to encourage employers to adopt full vesting. For the moment, we believe it should be retained. We recommend that the 125% test for retirement plans be brought into line with the eligibility rules of current law.

The proposed 125% rule needs modification in its application to welfare plans which permit, for example, optional forms of health coverage. These might be hi-option/lo-option arrangements. They might be arrangements made necessary by the HMO Act. Under certain circumstances, this Act requires an employer to contribute as much to the cost of optional HMO coverage as he is spending on the conventional arrangement.

We recommend that the employer be permitted to combine options, for the 125% test, wherever the employer's contribution is the same for each option. For this purpose, we recommend that an employee's cafeteria plan salary reduction contribution not be deemed an employer contribution.

Respecting reimbursement accounts, we believe we are missing an opportunity for health care cost control through plan design. We recommend that modest health care reimbursement accounts be permitted which are not subject to the use-it-or-lose-it rule. We recommend that these same modest accounts be exempted from the 125% usage test.

VOLUNTARY PERSONAL SAVINGS

ASPA is in sympathy with the need to curtail the use of tax favored savings for purposes other then they provision of retirement income. The President's Proposals relative to cash/deferred §401(k) plans will slow the development of these plans. Provided everyone recognizes this, the Committee may not find this slowing down objectionable. There are certain aspects of the cash/deferred proposals which do deserve revision, however.

First, the $8,000 limit is much too low. We recommend a $15,000 annual limit for cash-option deferrals.

Next, we recommend that both the contribution limit and the $200,000 covered compensation limit be indexed to inflation.

Next, we believe the upper/lower ratios of §401(k)(3) should be simplified. We recommend a flat two-times rule. Under existing law, the maximum permissible percentage is a permissible average. Under the Proposals, this maximum would have to be satisfied by each member of the upper group, individually. This is a significant tightening of the rules. Given this tightening, we believe our flat two-times recommendation is reasonable.

Consistent with our flat two-times recommendation, we recommend a flat one-and-one-half-times rule for employer matching contributions which do not satisfy the §401(k)(2) restrictions. Under the Proposals, the supposedly more restrictive rule for employer contributions will sometimes be more liberal. Fixing this inconsistency could involve a complex requirement. Our flat ratio recommendations avoid this problem and are generally simpler.

Next we recommend that recharacterization of an employee's salary reduction contribution into a non-deductible contribution be permitted as a corrective procedure. The I.R.S. seems to believe this recharacterization privilege would lead to "audit roulette." We believe this problem can be controlled through a tight time limit (perhaps one month) on the period after year-end during which recharacterization may take place.

In evaluating the rules on tax favored personal savings, we recommend that the Committee re-examine the rules on tax-sheltered annuities under §403(b) and deferred compensation under §457. It is not readily apparent why anti-discrimination rules should not be extended to these arrangements.

RETIREMENT PLAN BENEFIT DISTRIBUTION RULES

The proposed changes to exclusion ratio rules deserve rethinking. It is difficult to be sympathetic with the proposition that quinquennial grouping of recovery periods is necessary for administrative simplicity.

We find it objectionable, too, that the taxable portion of a monthly retirement check should increase if the recipient should outlive his recovery period. On the limited issue of calculation and application of exclusion ratios, we recommend that the Proposals be rejected. We do find the proposal to eliminate the three-year recovery rule entirely acceptable.

QUALIFIED RETIREMENT PLAN DEDUCTION LIMITATIONS

The Proposals would repeal profit-sharing credit carryover provisions for plans other than "retirement-type" plans. Retirement-type plans are defined in a manner which virtually precludes utilization of the exception. We believe credit carryover provisions serve a socially useful purpose. They permit an employer who must curtail contributions for business reasons to make it up to his employees in later years.

The proposal that profit-sharing limitations be applied on an individual basis should be tabled, pending a full review of social security integration.

We recommend that both the proposed credit carryover repeal and the proposed individual application of the 15% limitation be rejected.

IN-SERVICE DISTRIBUTIONS FROM TAX-SHELTERED ANNUITIES

New in-service distribution restrictions are proposed for tax-sheltered annuities established under §403(b). Under these rules, in-service distributions would be permitted, but only after age 59½.

We believe a consistent set of rules should apply to all work-related voluntary personal savings plans. If in-service distributions are to be precluded entirely for salary reduction contributions under §401(k), they should be precluded as well for similar contributions under §403(b) and §457 arrangements.

We recommend that an attempt be made to establish a uniform rule on in-service distributions from work-related voluntary personal savings plans.

ASSET REVERSION UPON PLAN TERMINATION

The Proposals would impose a 10% excise tax on asset reversions upon pension plan termination.

The question of asset reversion upon plan termination is difficult and highly charged. Some observers believe reversion should not be permitted al all. Others believe the problem of inappropriate termination should be attacked by permitting limited reversion from ongoing plans. This limited reversion provision might be coupled with a provision for a graded PBGC premium structure. In this way, the promise of a higher PBGC premium might serve as a disincentive to asset recapture.

In any event, the proposed 10% tax as an offset to the advantage gained through tax-exempt growth is entirely too inaccurate a form of justice. In some cases, it would be overkill. In others, it would be inadequate.

We recommend that the Proposal for a 10% tax on reversions be rejected. We believe the question of asset reversion deserves special attention and should not be made part of a general tax reform package.

ASPA is currently preparing a legislative recommendation on the issue of asset reversion. We expect to make it available to the Committee as soon as it is completed.

EMPLOYEE STOCK OWNERSHIP TRUSTS

The President's Proposals respecting ESOTs are commendable. We do suggest certain refinements.

First, we believe age, service and class exclusions should be permitted. We recommend that the rules and coverage discrimination tests here be the same as those which apply to retirement plans - with a waiting period not to exceed one year.

Next, we recommend that the $50,000 cap on covered compensation be indexed to inflation.

Next, we recommend that dividends and the passed through tax savings on dividend deductions both be eligible for rollover. This rollover would permit the participant to postpone what would otherwise be a taxable event. The vehicle receiving the rollover could be either an IRA or a qualified retirement plan. We recommend this treatment for dividends on allocated stock retained in the ESOT as well as dividends distributed from stock not yet allocated. This provision would offer a useful incentive for additional personal retirement savings.

Next, we recommend consideration of a pass through of all voting rights relative to unallocated shares. The Proposals include only a limited pass through.

Finally, we recommend that securities law be amended at the same time the new ESOT provisions are incorporated into the tax code. We recommend that the same registration exemptions now applicable to qualified plans be extended to these new programs.

* * * * * * *

ASPA is pleased at the opportunity to present its views to the Committee. We are eager to help the Committee and its staff in every way possible, as it pursues its consideration of the President's Proposals. We would welcome requests for assistance at any time.

Respectfully submitted by:

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July 26, 1985

Ms. Betty Scott-Boom
Committee on Finance
Room 219
Dirksen Senate Office Building
Washington, D.C. 20510

Dear Ms. Scott-Boom:

With reference to the hearing of Friday, July 19 of the Committee on Finance with regard to employee benefit programs, I am submitting the comments of the American Watch Association in opposition to the Administration's proposal to tax recipients of employee service awards in contravention of established Congressional intent.

Sincerely yours,

Emilio G. Collado
Emilio G. Collado III

Enclosure

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EMPLOYEE SERVICE AWARDS

Congress should reject the Administration's proposal to tax the recipients of employee service awards (President's Tax Proposals, Chapter 3.05):

- Congress established in 1962 and augmented in 1981 a special category of business gifts -- called employee service awards -- and created tax incentive for these items which the House and Senate agreed encourage employee loyalty and spur productivity. Service awards are items of tangible personal property -- not money or other forms of cash -- given to employees in recognition of length of service, productivity, or safety achievement. Section 274(b)(1)(C) of the Internal Revenue Code provides that an employee service award is deductible without regard to the $25 limit for other business gifts as long as it does not exceed $400 in awards, presented as part of a permanent, non-discriminatory plan, may be deducted to the extent that their average cost does not exceed $400 and their individual cost does not exceed $1600.

- Congress designed the service award incentive to limit the employer's deduction for the award at the same time that the recipient was accorded the right to exclude the award from taxable income. By denying the employee that right, the Administration's proposal would create a double penalty -- requiring includability in employee income at the same time limiting deductibility by the employer under Section 274(b)(1)(C). The Administration would thus nullify service awards which would be penalized by tax by comparison to simple cash compensation.

- Congress in 1962 and again in 1981 recognized the contribution of service awards to improving the quality and productivity of the American work force. Service awards have a proven track record of helping to reduce employee absenteeism and encouraging better employer/employee relations, both of which contribute to higher productivity. In addition, the need for such incentives is greater now than ever before to meet the challenge of foreign competition. The Administration's proposal to tax the recipients of employee service awards should be rejected.

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July 29, 1985

Before the
Committee on Ways and Means of the
United States House of Representatives

In the Matter of)
The Administration's Tax)
Proposal to Tax Recipients)
of Employee Service Awards)

Section 274(b)(1)(C)
of the
Internal Revenue Code

STATEMENT OF THE
AMERICAN WATCH ASSOCIATION

STATEMENT OF THE AMERICAN WATCH ASSOCIATION BEFORE THE HOUSE COMMITTEE ON WAYS AND MEANS WITH RESPECT TO THE TAX TREATMENT OF EMPLOYEE SERVICE AWARDS

In this statement, the American Watch Association expresses its strong opposition to the Administration's proposal to tax recipients of service awards given to employees for length of service, safety achievement and productivity. (President's Tax Proposals to Congress, Chapter 3.05.) The American Watch Association supports the preservation of current tax treatment that excludes from employee income an item of tangible personal property awarded to employees for such service or achievement under Section 274(b)(1)(C) of the Internal Revenue Code.

The American Watch Association (AWA) is a trade association of approximately 40 United States companies engaged in the importation, assembly and manufacture of watches and watch movements for sale in the U.S. and world markets. AWA members include the firms which market such well-known brands as Armitron, Baume & Mercier, Bulova, Cartier, Casio, Citizen, Concord, Corum, Ebel, Hamilton, Helbros, Jaz, Jules Jurgensen, Lasalle, Longines, Lorus, Marcel, Movado, Omega, Piaget, Pulsar, Rado, Rolex, Ronda, Seiko, Swatch, Universal Geneve, Wittnauer and many others.

Introduction

Section 274(b) of the Code limits deductions under sections 162 and 212 for gifts to individuals to no more than $25 per year per person, but permits additional deductions with respect to certain specified items. Among these items are articles of tangible personal property awarded to employees by reason of length of service, productivity, or safety achievement (so-called employee service awards).

Under section 274(b)(1)(C), an employee service award is deductible without regard to the $25 limit as long as its cost does not exceed $400 or it is a qualified plan award. Pursuant to section 274(b)(3), qualified plan awards -- defined as awards presented as part of a permanent, written plan or program that does not discriminate in favor of officers, shareholders, or highly compensated individuals -- may be deducted to the extent that their average cost does not exceed $400 and their individual cost does not exceed $1600.

The service award incentive was enacted by Congress as part of the Revenue Act of 1962, and amended by the Economic Recovery Tax Act of 1981 to encourage good employer-employee relations and to enhance employee productivity. These goals are every bit as valid today in the face of the challenge from foreign manufacturers and producers.

Excludability Is Essential For The Service Award Incentive

The Administration's proposal to include service awards in the income of employees would almost certainly kill the incentive program. In order to be effective, the service award incentive must confer a double, but limited, benefit. At the same time that section 274(b)(1)(C) limits the employer's deduction for a service award, the employee is not required to report the value of the award as income. The section imposes a $400 average limit on the benefit that results when the employer deducts the cost of a service award, but the recipient can exclude such a gift from income. Denying the right to exclude the value of the award from the employee's income would create a double penalty by requiring includability in employee income at the same time that deductibility by the employer is subject to the limitations of section 274(b)(1)(C). Thus, the Administration's proposal would nullify the service award incentive.

Congress, in enacting section 274 in 1962 and amending it in 1981, plainly understood the vital link between the excludability from the recipient's income and the service award incentive. The business gifts addressed in section 274 in 1962 were treated by the Administration, the House, and the Senate as items not includable in the income of the recipient.

See President Kennedy's Tax Message to Congress, April 20, 1961; Treasury Secretary Dillon's Detailed Explanation of the President's Recommendations Contained in His Message on Taxation, May 3, 1961; H.R.Rep.No.1447, pp.19-20, S.Rep.No.1881,pp.24-27, 33-34, 87th Cong., 2d Sess.(1962). Section 274 curtailed conceded compensation not by taxing employees but by restricting business deductions for "tax-free personal benefits."

The 97th Congress reaffirmed this intention in expanding the scope of section 274(b)(1)(C) in the 1981 Act. Reviewing a Senate floor colloquy, in which members of the Senate asserted that employee service awards are given to "motivate employees, cement employment relations, recognize loyalty" and for other business purposes, then Senate Finance Committee Chairman Dole (R.-Kans.) stated:

> I apprecaite the remarks of the Senators and I agree with their views. When section 274(b)(1)(C) was originally added to the Code in 1962, the Senate made it clear that:"...gifts for these purposes -- serve to strengthen the relationships between business and its employees (and) should not be discouraged by the tax law." (S.Rep.No.1881, 87th Cong.,p.34).

Service Awards Promote Employer-Employee Relations

Congress enacted the provisions of section 274(b)(1)(C) not out of largesse but in recognition of the valuable contribution employee service awards make to the American economy. Studies have shown that employees favor companies that give such awards for the following reasons:

- They show interest in and appreciation of their workers.
- They promote good employer-employee relations.
- They reflect a good company and good company policy.
- They keep employees loyal and encourage them to stay with the company.
- They generate better work from their employees.

A substantial portion of both employers and employees recognize the value of service awards in promoting greater production and employee dedication to the job. Employers have known this for years and have used service awards as an important part of their employee relations programs. They have used award programs to bolster productivity by:

- retaining key experienced employees over the years, thereby reducing worker turnover.
- reducing absenteeism and the need to use temporary and inefficient substitutes.
- offering incentives to employees who increase production and sales, who suggest procedures to streamline production techniques and who perform outstandingly well in their functions.

Conclusion

The service award incentive works for America and it does so by combining excludability from the employee's income with a realistic limitation on the deductibility of the cost of the award to the employer. The Administration's proposal to break that linkage and tax the recipient of service awards would nullify the incentive altogether. Employee service awards spur employee loyalty, reduce absenteeism and encourage productivity. Their proven worth to the U.S. economy greatly outweighs any miniscule revenue cost. Congress should reject the Administration's proposal.

STATEMENT OF BELLSOUTH CORPORATION ON PRESIDENT REAGAN'S PROPOSAL FOR COMPREHENSIVE TAX REFORM, HEARINGS OF THE U.S. SENATE COMMITTEE ON FINANCE JULY, 1985

BellSouth Corporation ("BellSouth") appreciates the opportunity to comment upon the employee benefit provisions of the President's Tax Proposals to the Congress for Fairness, Growth and Simplicity of May, 1985 ("Treasury II"). BellSouth's comments, as contained herein, are limited to the employee benefit provisions of Treasury II, and we do not intend to infer general support of, or opposition to, Treasury II.

I. Introduction

As you may know, BellSouth, a Georgia corporation, is one of the regional holding companies established as a result of the divestiture of American Telephone & Telegraph Corporation. Two of our subsidiaries, Southern Bell and South Central Bell, are corporations which provide local access telephone services to the American public in nine states: Georgia, Florida, Alabama, Mississippi, Tennessee, Kentucky, South Carolina, North Carolina and Louisiana. BellSouth and its eighty percent or more owned subsidiaries employ 97,000 people of whom approximately 50% are female and 19% are minorities. In addition, 25,000 retired employees participate in some or all of our employee benefit plans. Seventy-one percent of our employees are covered by collective bargaining agreements. We understand that we would be rated by Fortune 500 as the twelfth largest corporation in the United States were a rating based on assets. Our economic viability and employment opportunities are important throughout the Southeast. The Bell System, of which BellSouth used to be a part, historically encouraged employees to save for retirement. We have continued that tradition and appreciate federal tax incentives provided by Congress which have assisted our efforts.

A variety of employee benefits are provided to employees of the BellSouth controlled group of corporations, although not all of our corporation's employees participate in all plans. Among our benefit plans are two qualified defined benefit pension plans, a qualified thrift plan, a new qualified Section 401(k) thrift plan which we have adopted on a limited basis, an employee stock ownership plan, self-funded and insured medical benefit plans, self-funded short-term disability plans, a self-funded vision care plan, self-funded and employee-paid dental care plans, and several nonqualified deferred compensation and employee incentive award plans.

Union-eligible employees and the lowest paid two-thirds of all nonunion-eligible employees constitute 90% of our total employee population. All of our employees are eligible to participate in all of the plans adopted by their respective employing corporation on the same basis after satisfaction of minimal service and age requirements.

II. General Statement of Position

BellSouth opposes passage of the employee benefit provisions of Treasury II as currently drafted. Our opposition is premised upon three facts. First, the current tax treatment of employee benefits, especially qualified retirement plan benefits, encourages employers to provide for their employees out of corporate or business profits those necessities and that income protection which the federal and state governments otherwise would be forced to provide out of already scarce government revenues. Treasury II adversely changes the favorable tax treatment of many of these benefits and discourages employers from providing them in the future.

Second, while a few employers misuse tax-favored employee benefits (i) by providing benefits only to highly compensated employees and business owners and (ii) by effectively paying dividends and compensation to those groups in the guise of employee benefits, most employers use tax-favored benefits correctly, providing them to all employees on a basis as close to "as needed" as current law allows. Treasury II punishes all employers for the abuses of the few by proposing administratively costly and counterproductive changes in the tax treatment of benefit plans.

Third, employees frequently make job choices and choose among potential employers based upon the combinations of salary and employee benefits which those employers provide to their employees. For example, some employees choose companies which provide more employee benefits than other companies because those employees value benefits more than cash salary or have individual needs for those benefits. Concommitantly, employers compete in the labor marketplace in part by offering employees extensive benefits or, in some cases, larger salaries with fewer benefits. Treasury II indirectly condemns this operation of the free market system and minimizes the potential for employee and employer choice by restricting the favorable tax treatment afforded to employee benefits.

Where the drafters of Treasury II have recognized these natural, existing differences between various employers, employees, and businesses and have preserved the social welfare principles of the current employee benefit system, we support them; however, many of the proposed changes do not represent good public policy, and we recommend that Treasury II's treatment of the employee benefits area be examined closely and revised. Our comments on specific provisions follow.

III. Analysis of Specific Provisions

A. Taxation of Employer Provided Health Insurance. Chapter 3.01 of Treasury II mandates that an employee include in his or her gross income an amount equal to any employer contributions to a health plan for the individual or his or her family's benefit; however, no more than $10.00 per month for individual coverage for the employee or $25.00 per month for family coverage is included.

BellSouth opposes this change for two reasons. First, only the naive believe that the proposed imposition of a modest tax on health benefits will remain intact in the future or that the $10.00 per month maximum will continue. Yet, the provision radically changes the substantive tax treatment of employer-provided medical coverage now and in the future without any statement of long range policy aims. While BellSouth is not antagonistic to a comprehensive Congressional review of employer-provided fringe benefits, including medical benefits, BellSouth and all other employers have suffered over the past three years through several statutory and regulatory changes in benefit rules, and an air of uncertainty has been created in the business community as a result.

We encourage a comprehensive review of employer-provided fringe benefits only if Congress (1) designs and openly states a comprehensive, long-term federal tax policy and (2) implements that policy slowly and incrementally over two or three years. The latter condition is important because employers have relied upon current laws in making significant commitments to their employees in the benefits area. Medical benefits are an excellent example. We need sufficient leadtime to make those changes which Congress and the Reagan Administrative determine are necessary, and we need information concerning Congress and the Administration's long-term goals so that our incremental changes will not lead to a BellSouth benefit policy which is adverse to those goals. The new tax on employer-provided health coverage "hints" at a long-term goal, but it neither states such a goal fully nor provides any leadtime for a planned readjustment of our policies.

Second, while we recognize that the drafters of Treasury II have maintained a degree of revenue neutrality by increasing the amount of revenues obtained from the employee benefits sector, employer-provided medical plans should not be taxed because medical care is a fundamental necessity to all Americans and because the risk of large, uninsured medical care expenses weighs as heavily if not heavier on poor Americans as rich Americans. Although no statistical data is available in our records by which we can compare the selection of tax-favored employee benefits by a broad cross section of our employees if the benefits are alternatively (i) employer-provided on a nontaxable basis or (ii) employer-provided on a taxable basis, our general experience with our employees in designing and administering employee benefits plans is that the provision of employee benefits by the employer on a nontaxable basis maximizes our employees' selection of employee benefits over current cash compensation. We believe more employees will "plan" for medical expenses through participation in a comprehensive medical expense benefit plan if tax savings are involved and if the employer pays the cost of the benefit directly. Moreover, the less income that the employee receives during the year, the more likely he or she is to ignore the advantage of participation in a good medical insurance or medical benefit program. Thus, a shift to a system in which the employer provides medical benefits on a taxable basis would result in less participation, especially by lower-paid employees. Worse still, as the number of benefit plan participants decreases, the price of medical coverage for each remaining participant increases because only persons significantly at risk select coverage.

B. Repeal of $5,000 Exclusion for Employer-Provided Death Benefits. Currently, the first $5,000 of a death benefit provided by an employer to the employee's estate or beneficiary is excluded from the gross income of the deceased employee. Chapter 3.02 repeals the exclusion. While this change will increase BellSouth's withholding obligations, cause a revision in our administrative procedures for handling the exclusion, and, of course, subject many of the families of our employees who die to additional tax at the very time when the breadwinner's salary is lost, the adverse effect on BellSouth of this proposed change is not as severe as the effects of other proposed changes. We recognize that some increased taxation of employee benefits may be inevitable; if so, repeal of the exclusion is one of the least disadvantageous proposals.

C. Establishment of a Uniform Nondiscrimination Rule for Nonretirement Employer-Provided Benefits. Chapter 3.04 imposes a uniform nondiscrimination rule on group term life insurance plans, health benefits plans, group legal services plans, educational assistance programs, dependent care assistance programs, cafeteria plans, Section 132 benefits, such as the telephone concession, qualified tuition reduction plans, and welfare benefit funds. If a benefit plan is discriminatory under the rules outlined below, which rules closely parallel the existing cafeteria plan nondiscrimination rules, then the value of the benefit is fully includable in the gross income of all prohibited group members.

While we applaud the drafters' efforts to unify and simplify current nondiscrimination rules, the proposed rules should be extensively revised. We understand that the U.S. Chamber Commerce will soon release a comprehensive position paper on the nondiscrimination rule changes proposed in Treasury II. BellSouth has contributed to the Chamber's effort and supports its position. Nevertheless, because the nature of the nondiscrimination rules which are applicable to employee benefits plans is fundamental to our benefit planning, two comments by us are necessary.

First, the authors of Treasury II state in several chapters of the proposal that the tax expenditures which employee benefits represent are only cost-advantageous on a public policy basis if a broad cross section of employees receive those benefits. BellSouth disagrees with this statement. No one argues against the proposition that tax-favored treatment of employee benefits decreases the amount of revenue which the income tax system otherwise would produce. However, if the rules governing the taxation of those employee benefits force employers to provide benefits in a wasteful manner, albeit tax free, then an unnecessary loss to the United States Treasury occurs.

We believe that Treasury II is misguided in that its discrimination rules test receipt of benefits to a broad cross section of employees, not availability of benefits to a broad cross section of employees. The tax expenditure which employee benefits represents is most cost-beneficial if benefits are provided to a broad cross section of employees but only on an as-needed basis. The proposed discrimination rules often force employers to monitor the amount of benefits which are received by prohibited group and non-prohibited employees. BellSouth believes discrimination rules are proper if they force employers to monitor availability of benefits to prohibited group and non-prohibited group employees and require employers to expend a proportionate amount of money to provide benefits to those employees who want them.

Although non-retirement plan benefits are subject to three types of coverage rules in Treasury II, the key requirement is the requirement that the percentage of prohibited group members "actually benefiting" under a plan be no more than 125% of the percentage of other employees "actually benefiting" under the plan. An employer cannot force utilization by employees of benefits plans which are not insurance-based; therefore, the employer cannot assure by its actions that non-prohibited group members "actually benefit" from any plan. For example, in a medical expense reimbursement plan, employees actually benefit from the plan only if they seek reimbursement of a medical expense. The "actually benefiting" test will inhibit plans which provide benefits to all employees on an as-needed basis and encourage plans which provide benefits to a mathematically acceptable group of employees on a uniform and arguably wasteful basis. BellSouth recommends, as a minimally sufficient change, that the "actually benefiting" test be retained, but that employers be allowed either to satisfy that test or to satisfy some percentage eligibility test similar to the mathematical eligibility test currently contained in the group term life insurance rules.

Receipt of benefits not availability also is the basis of the concentration test imposed by Treasury II on legal services, Section 125, educational assistance, and dependent care benefits. Treasury II penalizes concentration of such benefits in the hands of the top twenty "prohibited group" members by compensation. The "prohibited group," as you know, is the group of employees against whom Treasury II's general discrimination tests are aimed. Unfortunately, this formulation of the concentration test implicitly recognizes that the prohibited group includes too many employees. If an employee "deserves" to be treated as a prohibited group member and not to be protected by the general discrimination rules, little justification exists for protecting that employee against cost-cutting moves by management aimed solely at prohibited group members. As well, the other general discrimination rules contained in Treasury II provide adequate protection to all employees and adequately assure that benefits will be provided to a broad cross section of employees. BellSouth also objects to the second part of Treasury II's concentration test, which requires that contributions "provided" with respect to a benefit for prohibited group members not exceed 25% of the total contribution, because the test imposed is based on receipt not availability.

Finally, Chapter 3.04 imposes a special receipt-based discrimination rule upon participants in reimbursement accounts maintained in cafeteria plans. Specifically, the average reimbursement for prohibited group members must not exceed 125% of the average reimbursement for non-prohibited group members. BellSouth urges the abandonment of this test.

Our second comment is that the proposed nondiscrimination rules for nonretirement employee benefits suggest insufficient concern by the drafters with benefit plan administration. Chapter 3.04 creates such serious administrative problems that our benefit planning will be impaired. For example, BellSouth supports the Reagan Administration's decision to consolidate the numerous definitions of the "prohibited group" which are currently contained in the Code; however, the current formulation of the concept creates administrative problems. We would prefer that the prohibited group consist of all Section 416 key employees or, at the very least, that the proposed categories of prohibited group members be revised. An employee receiving $50,000 or more of compensation should be a prohibited group member, as Chapter 3.04 provides, as long as Congress and the Administration agree that employees earning that amount are deserving of no protection under the discrimination rules.

The authors of Treasury II propose that the prohibited group include anyone who satisfies any of the criteria "during the three year period ending on the last day of the plan year." This three year "lookback" rule would be better timed it if were designed to end on the last day of the preceding plan year. Without this change, employers will be unable to identify prohibited group members until the end of the plan year in question since an employee's compensation, relative compensation, and stock ownership will change in many cases during the plan year. Especially if the discrimination rules are based upon receipt of benefits, not availability of benefits, the proposed three year "lookback" rule will create severe administrative hardships for BellSouth.

Moreover, a former employee's status as a prohibited group member is fixed under the proposal at his or her date of termination for all future purposes. We do not understand why this provision was included. Former employees tend to be older employees and, obviously, a large number of former employees are retirees whom Congress and the Administration should encourage industry to cover in its benefits plans. The discrimination rules as currently drafted would encourage employers not to provide benefits to former employees since former employees who were highly paid or who owned employer stock would complicate the employer's discrimination rules compliance. The drafters of Chapter 3.04 probably were concerned with the situation in which a family-owned or closely-held corporation provides benefits to family members or retired business owners. This situation is remedied by a narrower rule which states that a former employee is a prohibited group member only if (i) his or her family member currently is a prohibited group member and is currently employed or (ii) he or she continues to own more than 1% of the capital interest of the employer.

Finally, the stock ownership rule by which all 1% owners of the employer are prohibited group members will be difficult for us to administer. We are not necessarily be aware of all employees' stock ownership. Indeed, our stock transfer books may not reveal a short swing sale by an employee, and detecting ownership of stock which is attributable to employees will be impossible. A test which combines stock ownership with compensation, for example, a test for 1% owners earnings more than $150,000, at least identifies a workable group of employees. A 10% ownership test likewise establishes a field of prohibited group members which can be monitored effectively. We recommend that the 1% ownership rule be deleted or revised.

The penalty imposed on prohibited group members in a discriminatory benefits plan creates administrative problem in and of itself. Treasury II adopts a rule applicable already to some discriminatory benefit plans, that is, the exclusion normally applicable to the benefit will be forfeited in the case of plan discrimination for all prohibited group members. While the discrimination rules certainly must be enforced, loss of exclusion in the context of the new discrimination rules will cause problems. Initially, the exclusion will be either forfeited or preserved at the end of a plan year. The employer presumably will be responsible for income tax and employment tax withholding on the amount of this additional year-end income. Implementing increased withholding at the end of a plan year will be difficult, if not impossible in some cases, because of (i) other demands upon an employee's year end compensation, (ii) the difficulty in identifying the loss of the exclusion before the end of the plan year, (iii) the burden on employees who have planned for the use of their income in advance, and (iv) other practical problems. Also, many employees characterized as prohibited group members under the Reagan Administration's proposal have little or no control over the policy decisions made by the employer which will cause the loss of their exclusion. Fundamental fairness suggests that these prohibited group members not forfeit the exclusion. Especially because of this control element, BellSouth recommends that only those employees who have real control over policy decisions forfeit an income exclusion as a result of the violation of the discrimination rules. Perhaps the top twenty prohibited group members by compensation should forfeit their exclusion, if the drafters insist upon retaining the concentration test discussed above.

The administrative problems created by the "prohibited group" rules is compounded in the case of retirees. Chapter 3.04 generally requires that retirees be tested separately under the coverage, benefit, and concentration discrimination tests. A separate application of these tests to retirees is inapposite because the tests are dependent upon the term "compensation", which the retiree only has by analogy. Moreover, employers should be encouraged to provide benefits to any group of retirees because of their special status in the economy and the limitations of government programs for the aged. Finally, Treasury II ignores the simple fact that benefit programs change over time while retiree benefits remain more or less constant based upon the compensation rates in existence at the time retirement occurs. For example, as rates of compensation increase, retiree benefits which are based on compensation also increase. Therefore, the results reach under the discrimination tests will be skewed against some employers' plans by the relative ages of their retirees. Because of this problem and the administrative difficulties involved in obtaining and processing adequate information to administer the discrimination test for retirees, we recommend that this provision of Chapter 3.04 be deleted.

D. Limit Deduction for Meal Expenses. Treasury II provides that business meals are deductible only if furnished in a clear business setting and only to the extent that the total cost of the business meal is less than or equal to $25.00 per participant. Expenses above the $25.00 per person limit are only deductible at 50% of cost. Finally, expenses for food and beverage furnished on the premises of the taxpayer primarily for employees are not subject to the deduction limits.

BellSouth fully realizes that limitations on meal expense deductions are popular and that many Americans believe that meal expense deductions are per se abusive. While BellSouth understands the rationale supporting this proposal, Congress and the Administration should remember that business requirements actually do impose additional, unexpected meal costs on employees in many cases and that a reasonably structured deduction for business meals facilitates the functioning of modern businesses. We urge Congress and the Administration to insist upon definite statutory standards for determining when a business meal has occurred in a "proper business setting." Also, while a $25.00 limit is reasonable in most but not all cases now, that limit will be wholly unacceptable in five years or so, given inflation.

E. Limit Deduction for Travel Expenses. Treasury II also alters the treatment of travel expenses in four ways: (1) no travel deduction is allowed for travel assignments which extend for more than one year in one city; (2) absent proof of an existing medical reason for travelling by ocean liner, cruise ship, or other luxury form of water transportation, no deduction is allowed for this type of business travel in excess of the cost of otherwise available transportation; (3) no deduction is allowed for convention, seminar, and meeting expenses while aboard cruise ships; and (4) travel as a form of education is not deductible.

BellSouth objects only to the first limit on deductibility. Because of the nature of our business and the geographic area we service, we are forced to ask some of our employees to relocate for extended periods of time. At the time of our request, we know that a relocation of the employee's residence and family is not advisable because the work assignment is temporary. In those cases, a deduction for travel expenses even over a period of time greater than one year is appropriate.

F. Repeal of Tax Exemption for Large Credit Unions. Chapter 10.03 of Treasury II repeals the tax exemption currently applicable to the distributed and retained income of credit unions for those large credit unions with assets of at least $5 million.

BellSouth opposes repeal of the exclusion. The drafters of Treasury II apparently believe that the exclusion gives credit unions an _artificial_ market advantage over commercial banks. We disagree. Credit unions differ fundamentally from commercial banks in that credit unions are created by the pooling of the savings of people having an employment-related bond. This alternative source of investment savings should be encouraged not discouraged. Also, credit unions have traditionally offered credit to those persons who otherwise could not obtain needed credit from commercial banks.

G. _Increase in Spousal IRA Limits_. Chapter 14.01 of the Treasury's proposal allows a married couple filing a joint return, including a couple in which one individual has no annual compensation, to contribute the lesser of $4,000 or their total aggregate compensation to an individual retirement account ("IRA"). The Administration's concern with present law is that a married couple with a non-earning spouse is permitted to make total deductible IRA contributions of $2,250 while a married couple with a spouse who has compensation of less than $250 is only allowed to make deductible IRA contributions equal to $2,000 (for the spouse earnings more than $2,000) plus an amount equal to the other spouse's compensation, for example, $150.

BellSouth endorses any proposal which allows its employees to plan for their own retirement; thus, we support the change in the spousal IRA rules. We foresee that the personal savings "leg" of the three-legged stool, upon which the American retirement system is based, will increase in importance as government revenues decrease and as restrictions on employer-provided retirement plans increase. IRAs should be encouraged as a source of personal retirement savings.

H. _New Distribution Rules for Qualified Retirement Plans_. Chapter 14.02 is premised upon the Administration's desire to discourage early and lump sum withdrawals from qualified plans and to encourage true retirement savings in those plans. Generally, all distributions from qualified plans are taxable as ordinary income, the special capital gain, 10-year averaging, and unrealized appreciation rules being eliminated. Distributions received before a participant's annuity starting date are treated as a taxable distribution first, then as a nontaxable return of basis or the participant's own contributions. Also, any annuity distributions made after the participant's annuity starting date are taxed in accordance with the exclusion ratio established when distributions commenced, the three year recovery rule currently applicable being eliminated. The proposal sanctions early distributions from retirement plans, defined to include any distribution made before the individual's death, disability, or his or her attainment of age 59 1/2, by imposing an excise tax of 20% on the amount distributed. The rollover and plan transfer rules are restructured although the proposal does not indicate what new limitations, if any, will be imposed.

The impact of these new distribution rules on BellSouth's qualified retirement plans would be adverse and profound. Although the distribution rules contained in BellSouth's defined benefit pension plans would satisfy Treasury II's requirements with some modification, the Section 401(k)/thrift plans which we maintain would have to be amended massively. We believe that the net effect of these amendments would be to decrease retirement savings by our employees, fostering further dependence on government retirement programs in the future.

The discussion of the reasons for change which is contained in this chapter of the Treasury's proposal states that, "[t]he ability of individuals to gain access to the tax advantages provided to tax-favored funds before retirement permits employees to use tax-favored plans as short-term savings accounts rather than as retirement savings vehicles." While the argument that favorable tax treatment should be used only to "purchase" retirement savings has merit, BellSouth's experience is that the interest by employees in its thrift plans and Code Section 401(k) plans exists only because those plans offer the prospect of increased retirement income and contingency reserves or savings. Younger workers in particular seem to be unwilling to reduce their regular disposable income to make plan contributions if little or no access to contributed funds exists prior to retirement. Thus, while we agree that the primary purpose of our thrift and Section 401(k) plans should be retirement income security, excessive restrictions on distributions and contributions will be counterproductive.

I. Modification of Deduction Rules for Qualified Plans. Treasury II also imposes a new set of rules governing deductions for contributions to "tax-favored plans," primarily qualified retirement plans. The impact of the new deduction rules would be to decrease substantially the contributions to BellSouth's qualified plans which BellSouth could deduct in any one year.

The new rules provide that contributions on behalf of any individual to a profit-sharing or stock bonus plan may not be deducted in excess of 15% of that individual's compensation for the year. This rule replaces the current rule which states that aggregate contributions to a profit-sharing or stock bonus plan for all employees may not exceed 15% of covered compensation for all employees. Also, under current rules, contributions to a combination of money purchase pension plans and profit-sharing plans maintained by an employer, so-called "combination defined contribution plans," are deductible only to the extent of 25% of aggregate compensation. Chapter 14.03 of Treasury II expands the coverage of the rule and limits employer deductions for contributions to defined contribution plans and defined benefit plans to 25% of aggregate compensation paid to employees covered by the plan or, if greater, "the amount necessary to satisfy the minimum funding standard for the defined benefit plan."

Needless to say, BellSouth will not contribute nondeductible amounts to any of its retirement plans; thus, adoption of these limitations will decrease the retirement savings of affected employees.

J. Modification of Rules Applicable to Section 401(k) and Thrift Plans. BellSouth strongly endorses the continuation of Section 401(k) and thrift plans under the existing rules. These plans provide a means of employee involvement in saving for retirement. BellSouth implemented a revised thrift plan this year that incorporated a Section 401(k) feature. Our results indicate that 88.3% of the lower paid two-thirds participated in the plan with 63.4% electing salary deferrals of 6.6%. The upper one-third group had 93.7% total participation and 75.9% elected salary deferrals which averaged 7.0%. Obviously, the higher paid participants deferred approximately the same percentage of their income into our Code Section 401(k)/thrift plan as the lower paid, and the participation rates for the two groups were about the same.

1. Reduction in Annual CODA Contributions. The drafters of Treasury II propose a number of changes to cash-or-deferred arrangements (CODAs") such as BellSouth's Section 401(k) plans. We oppose the proposed decrease in the elective contributions which an employee may make to a CODA in one year to $8,000. The Section 415 rules which generally restrict contributions on behalf of an employee to 25% of compensation or $30,000 adequately restrict the receipt of tax benefits by an employee. The special CODA contribution limit apparently is designed to minimize the legal differences between CODAs and IRAs. However, Congress and the Administration should recognize and encourage the fundamental practical difference between IRAs and qualified retirement plans maintained by employers, that is, that IRAs are useful in encouraging retirement savings from excess year-end income of an employee while employer plans are useful in encouraging routine accumulations of retirement savings through a planned, annual program which the employee designs for himself or herself. Given the contrasting

uses of IRAs and CODAs, no attempt should be made to equalize CODA and IRA contributions limits.

We also oppose the provision of Chapter 14.06 which offsets IRA contributions against the above-described CODA limit. Our Section 401(k) plan is a current monthly payroll deduction plan while an IRA is an individual plan that can be funded anytime before April 15 of the following year. Clearly we will never be in a position to know the amount of an employee's IRA contribution in time to adjust Section 401(k) contribution limits.

2. Substitution of Prohibited Group for Highly Compensated Employees. Current law restricts contributions to CODAs on behalf of "highly compensated employees." Treasury II proposes that restrictions apply to "prohibited group members" instead of "highly compensated employees." The definition of prohibited group member parallels the definition of prohibited group member for non-retirement plan employee benefits. Our earlier suggestions are equally applicable here.

3. Revision of ADP Test. Chapter 14.06 proposes a new average deferral percentage (ADP) test which test requires that no prohibited group member have a deferral ratio in excess of the greater of (i) 125% of the ADP of non-prohibited group members or (ii) the lesser of 200% of the ADP for non-prohibited group members or the ADP for those members plus two percentage points. Contributions in excess of those allowed under the revised ADP test would not be deductible by the employer, would be subject to a 10% tax, and would have to be distributed to the prohibited group member by the end of the following plan year.

Admittedly, the existing ADP test is a receipt-based test, not an availability-based test as BellSouth would prefer. Nevertheless, the proposed changes increase the administrative difficulties which employers currently face by requiring that an employer compare the deferral ratio of every single prohibited group member with the average deferral ratio of the non-prohibited group members. Employers experience difficulty in timely and properly characterizing employees as highly compensated employees under the current ADP test. Timely and proper characterization of employees as prohibited group members under the proposed rules will be more difficult.

The proposed individual test will unnecessarily penalize those that are classified in the prohibited group. As noted, our experience is that, given free election, the upper paid one-third employees defer their income in a manner quite similarly to the lower paid two-thirds. Also, the proposed prohibited group designation attaches to family members of prohibited employees, and will attach to two worker families where both work for the same employer. This rule is too broad since both spouses will be considered members of the prohibited group even though one is employed at the lowest entry level job. Limiting the prohibited groups deferral for retirement savings will have a negative personal impact on the retirement lifestyles of some employees whose only retirement plan is a Section 401(k) savings plan.

4. Elimination of Hardship Distributions. Chapter 14.06 effectively eliminates hardship distributions from cash or deferred plans. We oppose this change because hardship distributions provide a valuable source of funds for employees who encounter situations that otherwise imperil their financial security.

5. New Non-discrimination Rules for Thrift Plans. We oppose the proposed imposition of new nondiscrimination rules on thrift plans. We are unaware of significant, recent abuses of the existing thrift plan rules which require legislation. Nevertheless, two sets of rules are proposed. One set of rules applies to employer matching contributions that (i) are nonforfeitable upon contribution, (ii) may not be distributed from the plan prior to the employee's death, disability or separation from service, or plan termination and (iii) do not exceed 100% of "the employees' mandatory contributions [which] would be required to satisfy the ADP test as if such contributions were elective contributions." Employer matching contributions which violate any one of the requirements are subject to a different set of rules.

We oppose the rules for two reasons. First, the rules as a whole illogically mix the drafters' desire to encourage only retirement savings with the drafters' desire to encourage provision of benefits to a broad cross section of employees. Under the rules, the discrimination test which is applied varies, in part, based upon distribution rules. A plan with more liberal distribution rules faces a more stringent discrimination test. Yet, contributions subject to a vesting schedule also are subject to a more stringent discrimination test even though vesting schedules tend to discourage distributions prior to retirement. We do not understand why application of discrimination rules should depend upon the three requirements discussed above.

Second, BellSouth's administrative costs and obligations will significantly increase as a result of the new rules. While an increase in the burdens of plan administration should not bar needed reform, we fail to understand how our thrift plan or any other thrift plan of another employer of which we are aware is abusive. At most, we would support a new rule providing that an employer's match of contributions by prohibited group members must equal the match of contributions by nonprohibited group members.

K. Modification of Code Section 410 Coverage Rules. The basic change in the Code Section 410 test which is proposed in Treasury II is the substitution of the 125% ratio comparison test proposed in other areas for the current 70% eligibility test and the facts and circumstances test of Section 410. Also, any classification of employees that is facially discriminatory is proscribed.

While an exception is provided to the facial discrimination test if the occurrence of an employee contribution is a condition precedent to receipt of an employer contribution, no such exception exists to the 125% test, and the adverse effect of integration on receipt of benefits also is not excepted. Both omissions create serious problems. More basic, if Congress and the Administration are dissatisfied with the facts and circumstances test, then we would prefer that the 125% test substitute for the facts and circumstances test. We oppose the removal of the 70% test since it is an objective test and since it guarantees that benefits are available to a broad cross section of employees.

IV. Summary

As noted, BellSouth opposes many of the changes in benefit plans rules which are contained in Treasury II. We appreciate the opportunity to express our concerns and hope that we can work with the Congress and the Administration to remedy the problems in the proposal that we have discussed.

STATEMENT
OF THE
BLUE CROSS AND BLUE SHIELD ASSOCIATION

ON

PROPOSALS TO TAX HEALTH BENEFITS

SUBMITTED TO THE
SENATE FINANCE COMMITTEE

JULY 19, 1985

The Blue Cross and Blue Shield Association, the national coordinating organization for the nation's Blue Cross and Blue Shield Plans, is pleased to submit for the record our comments on proposals to tax employer-paid health benefits. Today, Blue Cross and Blue Shield Plans provide health care coverage for more than 80 million Americans. Approximately 67 million of our subscribers maintain this coverage through group policies offered by their employers.

The Blue Cross and Blue Shield Association strongly opposes any taxation of employer-provided health benefits. The current tax treatment of health benefits plays a major role in assuring health protection for our citizens. Taxing health coverage would jeopardize that protection and impose a new tax on millions of Americans.

Current Tax Treatment of Health Benefits

Current tax policies encourage the provision of health benefits through employment by not treating the costs an employer incurs to provide these benefits as taxable income to the employee. In addition, the employer may deduct these costs as a business expense and does not pay payroll taxes — such as FICA and unemployment — on them. These tax policies have been a major factor in the growth of employment-related health coverage. Over three quarters of the labor force, or about 162 million employees and their dependents enjoy protection from the unexpected costs of illness through employment-related health coverage.

We believe that this country's extensive group health benefit coverage has substantial value for workers, employers, health care providers, the government, and society as a whole. Workers, including those who could not afford to buy insurance, or who would otherwise fail to purchase it on their own, are protected from the unexpected and major costs of illness. Health coverage administered and financed through a group mechanism is less expensive than if comparable insurance were purchased by individual workers. Moreover, the employer can serve a valuable role in the health benefits marketplace as a well-informed purchaser for his or her employees. In addition, employers are able to attract and retain workers by providing health coverage and including particular benefits. Finally, employee morale and productivity are enhanced as a result of increased job satisfaction, and this, in turn, strengthens our economy.

Current tax policy also has positive effects on our health care delivery system. By encouraging private group health benefits, providers of health care services, particularly hospitals, are assured of payment for their services. Blue Cross and Blue Shield Plans and insurers are able to play a major role in the avoidance of hospital bad debts, and that means a significantly smaller role for the federal and local governments in their support of community hospitals. In today's increasingly competitive health care market where employers are acting aggressively to contain their medical costs, a tax incentive for health coverage is even more important to assure access for lower-income workers.

Finally, existing tax policy reduces the need to expand government funded and administered entitlement programs by helping to make private health benefits available to those lower paid individuals who might otherwise look to government programs for health care. In short, the tax exemption for employer-provided health benefits should not be viewed solely as a source of lost revenue to government. It is a relatively efficient instrument of social policy. Because each business purchases health coverage through the marketplace, it can tailor the benefit package to the needs of its employees, retirees, and their dependents and the demands of its own industry. Each employer has a stake in control of health benefit costs, and innovative cost-containment mechanisms responsive to the local environment can be quickly tested and adopted. In contrast, a government program would have none of these advantages, yet would cost several times the expenditure resulting from the favorable tax treatment of employer-paid health benefits.

Group health coverage is an employee benefit that is critical to our nation's well-being and productivity. The favorable tax treatment of employee health benefits aids the vast majority of Americans rather than some special interest group. Consequently, we believe that the present tax treatment of health benefits should be maintained.

I would now like to address the major proposals to limit the current tax exclusion for employer contributions to health benefits plans.

Proposals To Tax Employee Health Benefits

The Administration has proposed to tax the first $300 of family health coverage paid by an employer and the first $120 of individual coverage — the so-called "health tax floor." The Administration previously submitted legislation to tax family coverage valued over $2100 annually and individual coverage over $840 - the so-called "tax cap". This "cap" proposal also was included in the Treasury study of November 1984. Senator Bradley's tax reform bill, S. 409, would tax the entire value of health benefits.

Proponents of taxing health benefits argue that the revenues raised could be used to reduce the federal deficit or that such a tax would be an effective way to control overall health care costs. We fail to see the merit of these arguments and furthermore, we believe that there would be serious adverse consequences for millions of Americans if a tax on health benefits were enacted.

Problems with Any Tax on Health Benefits

Any form of taxing health benefits would undermine and erode employer-paid health coverage.

- A tax would discourage this critically important employee benefit. Health benefits are not a luxury but a necessity to protect workers and their families from the unexpected and major costs of illness and injury. By taxing health benefits, the government would send a strong signal to our workforce and businesses that these benefits are no longer as important as they once were, and are less important than other employee benefits that would remain tax-exempt.

  A tax would begin to undermine the incentives that have led to three decades of progress in protecting workers and their families against the financial hazards of illness and injury. The current tax incentives for employer-provided health benefits recognize that many workers would otherwise fail to purchase health insurance on their own or seek to buy it only when the threat of illness or injury is apparent.

- A health tax would be a new tax burden on most working Americans and their families, not tax reform or simplification. Up to 162 million Americans could be affected by this tax. We believe that the majority of working Americans recognize that taxing health benefits is simply a new tax, and not tax reform. A Roper poll earlier this year found that 79% of Americans judged even partial taxation of health benefits to be "unacceptable," even if it would lower overall tax rates. In a recent industry survey of workers, while most thought the current tax system was unfair and too complex, a majority of those responding opposed taxation of employee benefits as a means to reduce marginal rates, to reduce the deficit or to make the system fairer.

- A tax would adversely affect lower-income workers. Lower-income workers would be imputed as having the same additional income from their health coverage as their higher-income co-workers. These lower-income taxpayers would tend to pay a greater share of new taxes, as a percent of income, than their higher-paid counterparts. In addition, lower-income workers would pay FICA taxes on this amount, while higher-income workers above the FICA ceiling would not. Moreover, regardless of what marginal rates apply, it should be recognized that lower income persons have less ability than higher income persons to bear any new taxes. As a result of this new tax burden, lower income employees might drop coverage or persuade their employers to help them avoid tax liability by reducing the benefit package. This could result in dropping important benefits or massive untargeted increases in cost sharing which would simply shift responsibility for payment rather than reward prudent use of health services. Such increases in cost-sharing or out-of-pocket costs for non-covered benefits also would affect lower-income persons disproportionately because they are less able to pay.

- Regardless of the initial level of a tax, the future temptation to increase it to obtain more revenues would be hard to resist. Any specific tax on health benefits is unlikely to produce the amount of revenue that proponents claim. For example, Treasury Department projections of revenues from health tax proposals are overstated because they are based on current tax rates, thus failing to account for lower rates resulting from tax reform. Moreover, the Congressional Budget Office estimates that the Administration's corporate tax proposals would lose $23 billion in revenue over the next five years, compared to Treasury's projection, and OMB is now forecasting a FY 1988 deficit of $175 billion even if all of the spending cuts now being discussed are enacted. These forecasts put tremendous pressure on this Congress and future Congresses to obtain additional revenues. Thus, raising the amount of health benefits subject to tax would be a tempting revenue source, but this would simply impose added tax burdens on the vast majority of employees and their dependents.

o A tax is not needed to promote cost containment. In the last few years, employers have been working with insurers to change their health benefits plans to make them more cost-effective. Increasingly, employers are asking employees to agree to greater management of their health care utilization through programs such as preadmission review, mandatory second opinion programs, and outpatient surgery requirements, and are introducing or increasing cost-sharing provisions to heighten awareness of the cost of care. These health care cost containment initiatives have resulted in the most dramatic changes in the health care industry in the last 50 years. For example, the Blue Cross and Blue Shield Federal Employee Program has proposed to rebate $754 million in premiums to the government and its employees, primarily due to reduced use of expensive hospital care.

These efforts are saving society billions of dollars in health care costs. Every day, the private sector is demonstrating its commitment to cost containment and displaying tangible results. Premium dollars are being spent more efficiently today than ever before. We are confident that further gains will result from this competitive environment where employers have a major incentive to contain their health benefit costs. A tax on health benefits is, therefore, not needed to encourage cost-conscious behavior and could in fact, result in less attention being paid to the difficult task of designing effective cost management programs.

- A tax would increase costs for employers and complicate collective bargaining. Payroll taxes paid by employers would increase if a tax on health benefits were enacted. In addition, workers affected by the new tax may urge employers to grant wage increases to offset their additional tax liability, which also would complicate collective bargaining. Administration of any tax on health benefits also may be burdensome for employers. For example, employers or the government would have to establish a new mechanism to collect income and payroll taxes for benefits of retirees and former employees with "conversion" coverage.

In addition to these general problems of any tax on health benefits, there are further problems with particular proposals to tax this coverage.

Specific Problems of a Tax "Cap"

As we testified at the July 1984 hearing of the Committee regarding the tax treatment of employee benefits, there are several problems specific to a tax "cap."

- A cap would impose a "sick tax" on older and chronically ill workers, and on their employers. Different employee groups have different health care needs. Because older and chronically ill workers tend to use more health benefits, the cost of providing health benefits to a group in which these workers are heavily represented will be higher than the cost of health benefits for a group of young healthy workers. Consequently, if a cap were imposed on the amount of employer-provided benefits, or for that matter if all of the health benefits were taxed, employees of companies with a relatively high percentage of such workers would have to pay more taxes than employees of other companies.

A tax cap could also have other serious, although more indirect, adverse effects on older and chronically ill workers. If employers responded to the tax cap by offering employees a choice of plans — a low option which is non-taxable and a high option which is taxable, those who perceive themselves as healthier likely would choose the lower-cost, minimal coverage plan. Less healthy workers would want the protection of a more comprehensive, higher-cost plan. Over time, the cost of providing services to the high users would drive up the premium of that group and consequently the healthier workers would drop out. This "adverse selection" would put the cost of the more comprehensive protection out of reach for those who need it most.

Blue Cross and Blue Shield Association actuarial simulations suggest how the cap proposal might affect older workers. The additional 1984 taxable income for family coverage provided by a particular Blue Cross and Blue Shield Plan was estimated to be 31 times higher for workers employed in older employee groups than in younger groups. This estimate compared a group of employees with average age of 55 to 64 to a group with average age of 35 to 44. Under the 1984 Treasury proposal, this would mean taxable income of $1,306 for the older group versus $41 for the younger group.

o A cap would be regressive taxation. Data from the Congressional Budget Office and the Employee Benefit Research Institute show that, of those employees who would be subject to additional taxes, the financial burden would fall heaviest on those with the lowest incomes. For example, under the proposed cap included in the 1984 Treasury study, workers who earn less than $10,000 a year would pay an additional 2.8 percent of their income on average. Workers earning more than $50,000 a year would pay taxes equivalent to only 0.4 percent of their income.

Specific Problems of a Tax "Floor"

A tax floor also would have several additional problems.

- A floor would be a hidden tax surcharge on a majority of families. According to Treasury Department figures, the tax floor would increase taxable income for 56% of all families, about 51 million families. The floor proposal amounts to nothing more than a hidden tax "surcharge" for a substantial portion of the workforce.

- A floor would hit low-income families the hardest. In addition to the other adverse effects mentioned earlier, the amount of tax paid by lower-income taxpayers would represent a larger share of their income on average than that of higher-income taxpayers' health benefits because these taxpayers tend to have less generous coverage than do higher-income taxpayers. The Employee Benefit Research Institute calculates that, as a percentage of income, a family with income of $10,000 to $15,000 would pay four times as much tax on average as a family making over $50,000.

- A floor could actually increase health benefits costs. A tax floor would set back many employers in their efforts to promote cost containment. The enactment of a floor would, overnight, reduce the net value of the health benefits that the employer provides. With a major reduction in the net value of health benefits mandated by the federal government as a result of the tax, employees would be less willing to accept cost-effective changes in their health plans. On the contrary, employees may argue for benefit expansions or reduced cost-sharing to offset the tax liability or may be encouraged to use more health services to "get their money's worth."

- o A floor is opposed by more people than any other major provision of the Administration's proposal. A recent Louis Harris/Business Week poll indicated that of 14 major provisions of the Administration's tax reform proposal, the tax floor received the least support from the public — only 26% of those surveyed supported it. The latest Washington Post-ABC News poll found that only 17% supported such a provision.

For all of these reasons, we believe that Congress should not impose any tax on employment related health benefits. The private system of providing health benefits through the workplace has been very successful. If any changes are made in the tax code regarding health insurance, they should be designed to further encourage the provision of health benefits by the private sector and not to discourage them as a tax would.

Some might charge that the current tax status of employer-provided health benefits is inequitable because it applies only to health coverage obtained through employment. While it is true that health insurance premiums for those who must purchase individual coverage are paid for with after-tax dollars, the medical expense deduction has helped mitigate this expense. If Congress wishes to address the differences in tax treatment of employer-provided versus non-group health coverage, we suggest reconsideration of the 1982 change which raised the threshold for claiming the medical expense deduction from three percent to five percent of adjusted gross income, and eliminated the separate deduction for health insurance premiums up to $150. Restoring the separate premium allowance, in particular, would represent at least a partial solution to this problem. Other approaches to provide tax incentives for the purchase of health coverage should also be considered.

Summary

In conclusion, we want to emphasize the value of using tax policy to encourage the private sector to provide benefits which protect our citizens from economic insecurity. With respect to health benefits, we strongly oppose taxation of employee health benefits, whether a "cap", a "floor" or some other approach. Such a tax is not needed and would hurt those most in need of health care.

COMMENTS TO THE COMMITTEE ON FINANCE
OF THE UNITED STATES SENATE
ON THE EFFECT OF
PRESIDENT REAGAN'S TAX REFORM PROPOSAL ON
EMPLOYEE BENEFITS

George T. Favetta
Chief Consultant

and

Frederick W. Rumack
Director of Tax and Legal Services

August 2, 1985

Over the years Congress has recognized the importance of employee benefits to the well-being of the American people and the American economy by enacting into law farsighted legislation in this area. We at Buck are concerned that provisions in President Reagan's tax reform proposal that affect employee benefits could significantly damage a benefit delivery system that is generally operating well and is benefiting the entire country. We are particularly concerned that this proposal would have the unintended effect of drastically reducing socially desirable and necessary benefits for the low and middle paid. Within this general framework, we will now discuss the particular benefit proposals in the President's tax plan.

Advantages of Defined Contribution Plans

We have had the opportunity to view the operation of many defined contribution plans, particularly savings and 401(k) plans as they actually work in practice. It has been our experience that, contrary to the opinion expressed by the Treasury and others, these plans fill an extremely valuable social need and national economic purpose by encouraging savings and capital accumulation for lower and middle paid, as well as high paid, employees. In fact, it is estimated that these plans now cover more than 30 million employees.

In many cases, these plans are the only vehicle that encourages employees to save their own money. These plans are usually designed to accomplish this objective by providing a company matching contribution that vests fairly quickly. As envisioned by Congress in legislating the Revenue Act of 1978, 401(k) plans have encouraged personal savings by employees of all classes and ages. This is in contrast to IRAs which have attracted mostly older and higher paid individuals.

Proposed Disincentives for Defined Contribution Plans

Without the encouragement given 401(k) and savings plans by the tax law, in many cases it is doubtful employers would establish or continue to maintain these plans. In fact, a number of employers we have spoken to would not today be offering a defined contribution plan for their employees, if 401(k) plans were not available. The proposal creates a number of disincentives to participation in these plans by all employees, but particularly by low and middle income employees. For example, 401(k) deferrals could no longer be withdrawn on account of hardship or attainment of age 59-1/2. Thus, employees would have to terminate employment to get their 401(k) deferrals.

Moreover, if an employee received matching employer contributions or 401(k) contributions before age 59-1/2, he or she would be subject to both ordinary income tax and a 20% excise tax on the taxable distribution unless a tax free rollover was involved. The 20% excise tax would be reduced to 10% but only if the money was used for certain socially desirable purposes such as the purchase of a first primary residence. These provisions alone would be enough to discourage participation by all employees. In particular, low and middle income employees, -- especially in an environment in which income tax rates were lower -- would look for other less effective savings vehicles where their money was available without penalties or restrictions or they might very well spend rather than save the money. If the lower and middle income employees do not participate, a plan would not be able to pass the new proposed coverage and nondiscrimination tests, thus jeopardizing the establishment of new plans and the continuation of existing plans.

The new cap on an individual's 401(k) deferrals would be a further disincentive. These would be limited in one year to $8,000 minus an individual's contribution to a personal IRA. This would further cause 401(k) plans to lose their appeal to higher paid employees and their employers. On top of this, the proposals would eliminate the favorable tax rules currently available for lump sum distributions. While this would affect high income employees significantly, it also would adversely affect employees who are not high paid. Another disincentive to savings would be the proposal to subject annual benefits to an individual from qualified plans and an IRA to a 10% excise tax on amounts in excess of $112,500. This could discourage participation in qualified plans or IRAs, or both types of plans.

While our comments thus far have largely focused on 401(k) plans, which by far have been the most successful plans yet devised to encourage employee savings, the proposal would also adversely affect after-tax savings plans. In the case of these plans, employee withdrawals, where permitted, would be first considered to be a withdrawal of taxable monies, rather than a withdrawal of an employee's after-tax contribution which is generally the case now. Thus, the withdrawal would be subject to both ordinary income tax and the proposed excise tax.

It is our belief that these disincentives will also lead many employees to forgo participation in savings plans, or severely cut back on the amount of their savings under these plans. The effect of this would be to reduce the overall savings by millions of Americans. Although we believe most existing plans would be continued by employers, the savings rates of employees in these plans would likely be reduced and the establishment of new plans would be slowed. We believe for the long term good of the country, the economy and employees, that savings and 401(k) plans should be encouraged, not discouraged.

Our general position is that none of the proposed changes in the President's tax plan should be made to the current rules for 401(k) and savings plans. In particular, the proposal must be modified as follows in order to maintain the continued vigor of these plans --

. The elimination of the excise tax on premature withdrawals;

. The continuation of the current rules on withdrawals from 401(k) and savings plans;

. The elimination of the new deferral test under 401(k) plans and savings plans under which the deferral percentage of each individual member in the prohibited group would be measured against the average deferral for other participants; and

- The continuation of the current 401(k) percentage deferral test. It is our belief that an annual cap on employee deferrals, such as $8,000, which we feel is too low, would be sufficient to avoid any perceived abuses.

We do not favor reducing the $8,000 maximum deferral for an individual under a 401(k) plan by the individual's IRA deduction. However, if this is enacted, the burden of compliance should be placed on the individual not on the plan.

ESOPs

We are pleased that the incentives for employee stock ownership plans would be continued.

Flexible Benefit Plans

We are pleased that the proposal would retain Section 125 flexible benefit plans. However, there are problems with the proposed nondiscrimination rules for these plans.

Proposed Nondiscrimination Rules For Pension and Welfare Plans

We have talked about Buck's concern regarding the proposed new nondiscrimination tests under 401(k) plans or other savings plans. We in fact are equally, if not more, concerned about the proposed nondiscrimination rules with respect to coverage under pension and welfare plans. While we can appreciate that Congress wants to be sure that these plans do not unduly favor higher paid employees and substantial stockholders, we also feel it is important not to make these rules so complicated that compliance would lead to unrealistically high administrative burdens for both the company and the IRS.

These rules could have an undesirable effect where several benefit options are offered under a welfare benefit plan such as under a medical plan. Each benefit option would be tested separately by participation. For cost containment and other reasons many employers have established various levels of medical benefits with different costs which may be elected by an employee to meet his or her own needs. By doing so, employers have been able to contain medical costs by permitting employees to elect only the level of benefits which they need. The need for medical benefits may vary among employees for many reasons, including geographical location or coverage under a spouse's plan. Generally the elections made by employees in these cases have nothing to do with discrimination. Therefore, testing on the basis of participation rather than on the basis of availability could produce unintended results, such as an employer offering only a modest low cost medical benefit program with no choice for employees.

We are especially concerned about the proposal to base the discrimination tests on all the employees of a controlled group. In today's environment it is not unusual for a company to operate in several businesses with different profit margins and various degrees of emphasis on fringe benefits. To require essentially equal benefits in both pension and welfare plans for disparate groups of employees merely because they are part of the same controlled group could mean that the benefits of many employees -- including the lower paid -- would be reduced in order to maintain comparability with other employees in an entirely different business or geographic location.

Proposed Tax on Health Insurance

We also would like to express our concern about the proposed tax on the cost of employer provided health insurance. While the proposed imputed costs of $10 for a single individual and $25 for a married person are modest, we fear the initial amounts might well be merely a starting point and could increase in the future. Moreover, they could produce inequities and could lead eventually to the taxation of other socially desirable benefits.

Proposed Tax on Asset Reversions

In addition, we would like to comment on the proposed 10% tax on asset reversions from terminated pension plans. Under a defined benefit retirement plan the employer bears the risk of unfavorable investment performance. Therefore, it appears to us that the employer also should receive the benefit of favorable investment performance to the extent that assets more than cover the value of the benefits which employees have earned. Under ERISA employers have considerable latitude in selecting the funding level for a retirement plan. The proposed 10% tax could have the undesirable and unintended effect of encouraging employers to fund their retirement programs on the minimum basis permitted by law. This would erode the benefit security of plan participants and could increase the potential liabilities of the PBGC in the event of future plan terminations. Therefore, we believe the long range effect of this proposal would not be in the best interests of millions of retirement plan participants.

Proposed Denial of 401(k) Plans to Public and Nonprofit Organization Employers

Lastly the proposal would eliminate the availability of 401(k) plans for public employers. The rationale of the proposal is that governmental employers can sponsor unfunded IRC 457 plans. We question why public employees should not have the security of a funded plan, such as a 401(k) plan, to defer compensation. The progress toward equality between the public and private sector should not be allowed to regress. Thus, to treat governmental employees fairly, a funded qualified plan such as a 401(k) plan should continue to be permitted for these employees. It would be reasonable to coordinate the 401(k) and 457 plans so that 401(k) deferrals would reduce the maximum allowed under the 457 plan rules. Also, in recognition of the salary levels of governmental employers, we feel that testing for discrimination by comparing higher paid and lower paid employees should be eliminated.

Likewise, we believe that employees of nonprofit employers should be offered 401(k) plans with appropriate coordination of 403(b) and 401(k) plan benefits.

Conclusion

After carefully considering all of the pertinent points, Congress may decide that some major changes are needed regarding the taxation of employee benefits. If this should occur, we hope that Congress will enact changes only after considering the long-term effects they would bring. America's benefit delivery system works well. With the various incentives offered by current law, even more employees than now should be covered by qualified plans in the future. The President's proposal, in our view, would reverse this desirable trend.

Finally, in any event, we urge Congress to include realistic transition rules to safeguard employees and their employers against the drastic effect of sudden changes.

BURGER KING CORPORATION EXECUTIVE OFFICES: 7360 NORTH KENDALL DRIVE

STATEMENT OF
THE BURGER KING CORPORATION
IN SUPPORT OF

CODE SECTION 127
EMPLOYEE EDUCATIONAL ASSISTANCE

SUBMITTED TO
MEMBERS OF THE UNITED STATES
HOUSE COMMITTEE ON WAYS AND MEANS
SENATE COMMITTEE ON FINANCE

September 4, 1985

CODE SECTION 127 EXCLUSION FOR EMPLOYEE EDUCATIONAL ASSISTANCE

A. Introduction

The Burger King Corporation firmly supports the Administration proposal to make employee educational assistance a permanent part of the Internal Revenue Code. The Company further recommends important modifications to the Code which are intended to result in greater use of qualified educational assistance programs in appropriate cases.

For more than 30 years, the Company has been committed to America's most valuable resource -- its people. Providing jobs, training, and direction each year to more than 50,000 employees across the country, no company is more keenly aware of the importance of education. In the Company's view, employee educational assistance must be made a permanent part of the federal tax code today to assure a brighter, more rewarding future for our men and women of tomorrow.

Burger King is committed to a fundamental policy which inextricably links national educational priorities to the continued progress of the Company itself. The Company's official policy, incorporated into its formal educational assistance plan document, states:

> 1.01 The Company hereby adopts the Burger King Crew Educational Assistance Program (the "Plan") for the purpose of furnishing certain educational assistance to Employees to further their post-high school

> education and establishing a defined program through which the Company can contribute to the advancement of the national educational system.

The Burger King Corporation respectfully requests the Committees' support as the Congress reconvenes and attention is turned, once again, to the formulation of comprehensive tax reform. The Company urges members of the respective Committees to give careful consideration to employee educational assistance particularly in light of our country's long-range national interests and continue to find Code Section 127 to be a fair, simple, and effective means to that end.

B. Present Law and Practice

1. Present Law

Section 127 of the Internal Revenue Code was originally enacted in 1978 to give employees, for the first time, the opportunity to receive tax-protected educational assistance in fields not required to be directly related to present job skills nor necessarily tied to courses of instruction forming a part of a formal degree program. The primary purpose was to give a helping hand to lower income employees by making tax-favored assistance available in technical, vocational and similar fields of training.[1/]

[1/] S. Rep. No. 1263, 95th Cong., 2d Sess. at 102; see also the recent holding in Wheeler v. U.S., No. 85-533 (Fed.Cir. 7/25/85) providing that, in connection with educational reimbursement plans, Congress intended educational benefits to extend to non-key employees and ". . . made clear that nondiscrimination is 'an important common thread among the types of fringe benefits which are excluded' from taxation" citing H.R. Rep. No. 432 (Pt. 2), 98th Cong., 2nd Sess. 1590, 1592 (1984).

Code Section 127 allows an employee to exclude from his or her gross income the value of employer-provided educational assistance up to a maximum of $5,000 annually. To qualify for the income exclusion, the assistance must be provided through a separate written plan which, taken as a whole, assures that it is strictly educational in nature, not a disguised form of other compensation, and made available on a uniform, nondiscriminatory basis for the exclusive benefit of all eligible employees. Treasury Regulations have been adopted interpreting the Section in a manner generally consistent with the Code and legislative history. Although an advanced ruling determination is not required to qualify an educational assistance plan under Code Section 127, the Internal Revenue Service will entertain, and has issued, rulings for that purpose.

The Secretary of the Treasury is required to conduct a study of the effect of Code Section 127 and report to the House Ways and Means and the Senate Finance Committees not later than October 1, 1985.[2] Code Section 127 and the related reporting requirements enacted through Code Section 6039D in 1984 are due to expire on December 31, 1985.

2. National Findings

Statistical and empirical data indicate that Code Section 127 can be an important factor in improving the educational skills and literacy of the American work force. A nationwide survey conducted by the American Society for Training and Development ("ASTD") in March, 1985 found that employee educational assistance:[3/]

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[2] Educational Assistance Programs, P.L. 98-611, § 1(h), 98 Stat. 3176, 3177 (1984).

- Is offered by a broad and diverse cross section of employers;
- Is utilized by employees at different compensation levels with the highest concentration in the low-to-middle income ranges;
- Helps laid-off workers to obtain new skills;
- Allows employers to offer cost-effective programs for upgrading skills of employees; and
- Encourages workers to keep up to date with new technological and industrial developments.

According to the ASTD report, a clear connection was established between employer-provided educational assistance on the one hand and increase in productivity and improvement in basic literacy skills on the other. Word processing, computer literacy, business English, and technical vocational skills were specific areas of improvement.

3. The Burger King Pilot Program

Burger King conducted its own pilot educational assistance programs in the New York and Atlanta regions in January and March, 1985, representing a 20% sampling of the then extant Company domestic restaurant operations.

[3/] The American Society for Training and Development specializes in work place training and human resources development. The organization's Government Affairs Director testified before the House Ways and Means and Senate Finance Committees on July 10 and July 19, 1985, respectively, in support of Code Section 127.

Under the programs, educational assistance benefits were earned by hourly-paid employees, many of whom are minorities and young adults, based upon length of continuous service. So long as the employee did not terminate employment, educational benefits accrued in his or her favor according to a vesting schedule. Educational assistance to be paid by the Company was not required to be job-related.

The Company's test results generally agree with the national findings stated in the ASTD report. The results show employee turnover reduced and that employee morale and productivity increased as a consequence of implementing a well-planned educational assistance program. All of the program participants, in addition, now have financial assistance earmarked for further educational purposes.

Of special significance in the Burger King test case is the particular impact on young adults and minorities. The following table indicates the Age Group Profile of the fast food restaurant industry; the Company's own work force substantially parallels the industry profile.

Fast Food Industry
Age Group Profile

Age	%
Under 21	75.00
21-30	22.00
31-50	2.50
Over 50	.03

Further, 41% of the Company's employees are of minority groups. In view of this labor profile, clearly Burger King's plan makes a positive contribution toward the long-range national goal of educationally assisting the jobless.

C. The Burger King Proposal

Burger King generally adopts the Administration proposal for Code Section 127. However, as explained below, the Company would expand the Section's coverage through use of various well-known tax concepts to permit a more complete realization of its clear purpose.

The Administration proposal would make three changes to Code Section 127 effective January 1, 1986. They are:

- The exclusion for employee educational assistance would be made permanent;
- The $5,000 annual cap on excludable employee educational assistance would be repealed; and
- The specific nondiscrimination rules presently existing in Section 127 would be repealed and replaced by a new set of uniform nondiscrimination rules applicable to all types of statutory benefits.

The Code should provide a clear, unwavering commitment to the advancement of national educational goals. The Company therefore strongly supports the Administration's first change, to make Code Section 127 permanent.

The Company also supports the Administration's second change while recognizing that only in extreme circumstances would a person (also capable of working while in school) require more than $5,000 per year and further recognizing that if the cap were raised or eliminated that effective safeguards would have to be considered to assure that the Section were not abused.

. The Company does not support all aspects of the Administration's third change -- new nondiscrimination rules -- because the Company believes that certain of the new rules would, in practice, not achieve tax simplification. The Company believes that the nondiscrimination rules presently existing in Code Section 127 are simple and fair, and should not be changed.[4] The nondiscriminatory coverage and concentration tests contained in the new rules are more complex and would add to the administrative expense of plan operation. Further, while the call for "uniform" rules is at first blush an appealing argument for "tax simplification", significant differences between educational assistance and other types of statutory fringe benefits make uniform rules inappropriate.[5] The existing nondiscrimination rules provided in Section 127 were tailor-made when enacted, have been time-tested, and to the Company's knowledge, are operating effectively. If there is evidence of abuse, the Company would support an Administration proposal which effectively addresses the abuse without undue complication.

4/ Burger King notes that its own educational plan would qualify fully under the Administration's proposed rules as well as the present rules.

5/ Unlike other types of statutory benefits, participation in an educational assistance program by an employee is "voluntary" as it relies totally on the employee's "willingness to sacrifice free time to participate". Applying mechanical coverage tests uniformly to programs, some of which are voluntary and others of which are not (e.g., medical insurance, health benefits and group-term life insurance), is operationally burdensome and substantively inappropriate. (See Statement of the American Society for Training and Development before the Senate Finance Committee at pp. 9-10, July 19, 1985.)

While not supporting the Administration nondiscrimination rules as to coverage and concentration tests, the Company finds the Administration proposal regarding sanctions constructive. The Company agrees with the Administration proposal that only those who have benefited from unlawful discrimination should be penalized, rather than disqualifying the entire educational assistance plan as under present law.

Finally, Burger King recommends adding a new, major piece to the proposal: to effect statutory changes permitting all employees of a common economic enterprise, whether or not technically employed by the same employer, to receive benefits under a master educational assistance plan. Recognizing that many major corporations conduct multi-state operations through affiliated corporate groups, distributorships, and franchise relations, that the employees of such commercial networks often share a common employment bond, and that in our transient economy persons would like to move freely within the system geographically without loss of benefits, such statutory changes would make Code Section 127 more responsive to business practice and increase its use. By making Code Section 127 more easily adaptable to different business environments, the Section would come into true alignment with its oft-repeated legislative purpose of giving broad educational opportunity to those who historically have been denied it. (A more detailed explanation of this proposal is provided in Parts D and E hereafter.)

D. Reasons for the Burger King Proposal

From the inception of Code Section 127 in 1978, Congress recognized the need to extend educational assistance to those who in the past have been denied it. The Senate Conference Report states:

> More serious even than the potential inequities of administration and the complexities of the tax law is the disincentive to upward mobility. Although most citizens recognize the need to provide greater access to educational and economic opportunity to those who have had limited access in the past, the tax law presently requires out-of-pocket tax payments for employer-provided educational assistance from those least able to pay, even though they receive only services, not an increased paycheck. 6/

The Company plan gives educational assistance to those who have had "limited access in the past" -- our country's youth under 21, minority groups, those residing in rural areas, and those of lower socio-economic status regardless of age who seek vocational and technical training. If the Burger King program were to be effectively extended to all employees of the Burger King system - employees of both Burger King (franchisor) and Burger King franchisee owned restaurants - through appropriate changes in the Code, "limited access" would be transformed into an "open door" of opportunity to thousands of men and women across the country. Burger King restaurants serve (and are served by) men and women of every age and socio-ecomonic level in every state. The restaurants exist in most rural and less

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6/ S. Rep. No.1263, 95th Cong., 2d Sess. at 101.

populated areas as well as the major cities. Bringing the employees of all Burger King (franchisor) and franchisee owned restaurants under the umbrella of a common employer educational assistance plan could potentially turn the Burger King national franchise system into a national distribution system of educational benefits.

The advantages of such an approach may be summarized:

- Those who have the greatest need for educational assistance would have greater opportunity;
- Geographic distribution of educational assistance would be improved as individuals residing in rural and less populated regions would have access to educational opportunities equal to those residing in major cities;
- Federal government administration would be reduced as fewer annual plan reports would be filed; and
- Taxpayer abuse would be less likely to occur because educational assistance plans would be larger and easier to monitor.

E. Burger King Statutory Modifications

Code Section 127 should be modified to achieve the advantages, indicated above, using several well-known tax concepts. These include authorizing the use of multiple employer plans, expanding the definition of "employee" within Code Section 127 to extend to former employees, recognizing employee prior service credit, and permitting educational assistance plan mergers and divisions. Each of these possible approaches is described briefly as follows:

- Authorize "multiple employer" plans. This would allow a small firm having an established commercial relation with a larger firm or several firms constituting a common economic enterprise (e.g., franchisor-franchisee, parent-subsidiary, etc.) to adopt or subscribe to a master educational assistance plan. All employees sharing the common bond of employment within the established commercial relation would be allowed to participate under the plan. Plan and government administrative expenses would be reduced as fewer plans are created. Greater access to employer-provided educational assistance would result as firms, which ordinarily acting alone would not have the expertise or encouragement to adopt an educational assistance plan, would become plan sponsors for the first time. Using a "multiple employer" plan in the Company's case would mean that all Burger King franchisees nationwide would subscribe to the Burger King (franchisor) master educational assistance plan, thus having a single IRS ruling determination, a single annual report, and a single plan administrator.

- Expand the definition of "employee" to include a former employee. This would allow an individual to earn "educational credits" during active employment based upon continuous service and thereafter terminate employment for the purpose of pursuing educational instruction on a full-time basis, which is not job-related and with no obligation to return to the service of the original employer. Educational assistance provided by the original employer in such a case to the former employee would qualify under Code Section 127 and be deductible by the original employer when paid. Again, in the Company's case, and the fast food restaurant industry generally, this would allow the labor force, principally those under the age of 21 and minorities, to be able to earn their education tuition and then truly have the opportunity to use it most effectively.

- Recognize employee prior service credit. This would allow an employee who changes employment to receive credit under the new employer's educational assistance plan for substantially similar service performed for the prior employer. Greater job transfer and geographic mobility without loss of educational benefits would result. Particularly in industries where major firms conduct multi-state operations, an employee would be permitted to move within the overall commercial network more freely.

- Permit plan mergers and divisions. This would allow educational assistance programs to survive certain types of corporate acquisitions or reorganizations in the same manner as qualified retirement income plans. Educational assistance would assume a status, as a type of employee benefit, equal to retirement income. In the fast food restaurant business, a franchisor frequently sells, or is required to repurchase, restaurant locations. In such transactions, all parties desire to avoid any harmful or disruptive impact on the employees involved. Liberal plan merger and division rules would help achieve those goals.

The foregoing concepts have operated successfully with respect to qualified retirement income plans for many years. It is beyond the scope of this statement to describe the reasons therefor or the circumstances in which such concepts are most appropriate. It is certain, however, that they have had the effect of expanding the use and viability of retirement income plans and with careful consideration could be applied effectively to Code Section 127.

F. Revenue Impact

The Company believes that the continuation of Code Section 127, even in the broadened form recommended here, would be revenue neutral to the federal government in the short-run and revenue positive over the long-term.

Existing data indicates that middle and lower paid employees are the largest beneficiaries of employer provided educational assistance. As a group, these individuals are low bracket taxpayers, and accordingly the income tax revenue loss associated with providing an income exclusion to them should be small. In the case of the Company (and the fast food restaurant industry), with 75% of the labor force under the age of 21, the effective tax rate of the beneficiaries is even lower than the general case.

Most individuals under 21 have little or no taxable income, even those having part-time employment. An income tax exclusion for educational assistance would thus have nominal or nonexistent negative revenue impact. Moreover, in that the earning of educational benefits is often linked to continuous service requirements (as in the Company's plan), the government should actually collect more payroll taxes (as distinguished from income tax) than it otherwise would had the employee terminated service. Employees who are given the opportunity to earn educational benefits through continued employment respond. They work longer, uninterrupted periods, contribute more to the employer through reduced turnover and greater productivity, and ultimately pay more into the social security system. The additional payroll taxes collected through continuous employment should offset any possible loss of revenue from the income tax.

Finally, it has long been recognized that improved skills through education lead to upward economic mobility -- up the ladder to better jobs -- and commensurate higher salaries. Higher salaries, in turn, mean higher income taxes over the long-term, as well as a more vibrant economy.

Summary

Code Section 127 has been effective since its enactment in 1978. The Section has proved itself worthy of reenactment and should be made a permanent part of our federal tax laws. The changes suggested here would strengthen the Section and therefore deserve further consideration.

The Burger King Corporation is pleased to submit its views to the respective Committees and urges the Committees to act positively for employee educational assistance. Perhaps no other tax provision before the Committees this year truly meets the high standard set by the President and the Congress of tax reform to achieve "fairness" and is so in line with America's national interests.

Respectfully submitted,
The Burger King Corporation

September 4, 1985

STATEMENT
on
EMPLOYEE BENEFITS TAXATION
for submission to the
SENATE COMMITTEE ON FINANCE
for the
CHAMBER OF COMMERCE OF THE UNITED STATES
by
James A. Klein*
July 30, 1985

On behalf of the Chamber of Commerce of the United States, the largest federation of business and professional organizations in the world, I am pleased to submit this statement on the employee benefits provisions of the President's Tax Proposals to the Congress for Fairness, Growth and Simplicity.

The Chamber applauds the President and his Administration for developing a comprehensive and constructive tax reform proposal. The Chamber hopes to testify in September before this Committee in support of tax reform which would continue to increase economic growth by stimulating capital formation, technological advancement, international competitiveness, and job creation. We also appreciate the opportunity to share with the Committee the Chamber's thoughts on employee benefits taxation, generally, and the employee benefits portions of the Administration's proposals, specifically, with a view toward assisting the Committee in its important tax reform endeavor.

I. THE SUCCESS OF THE PRIVATE SECTOR EMPLOYEE BENEFITS SYSTEM

The U.S. Chamber supports the development and maintenance of a strong, voluntary, nondiscriminatory, private sector employee benefits system, which can vary in accordance with the needs of employers and employees. Accordingly, proposals to subject employee benefits to taxation and further regulation concern us.

The Reagan Administration has been committed to less government intrusion into business. Its goals of privatization and deregulation of certain government services are shared and supported by the Chamber. The proposed new rules regarding distribution and nondiscrimination requirements for employee benefit plans are inconsistent with these goals.

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Incentives for business to offer health and insurance benefits to employees reduce the utilization of and pressure on government-provided services. Reduced regulation and taxation of employee benefit plans would reduce business costs and allow greater flexibility in choice of benefits for workers. The Employee Benefit Research Institute (EBRI) estimates that the $100 billion of health coverage provided by employers to some 82 million workers costs the government less than one-third of that amount in foregone taxes. The replacement cost of similar health protection provided directly by the government would be the full $100 billion.

Employer-provided benefits thus fulfill a number of worthy objectives, including the maintenance of a less extensive and less costly Social Security system, avoidance of the burdens of a broadly based national health system, encouragement of a sense of affiliation with an employer leading to increased employee productivity, and provision of an important source of savings and investment and substantial risk protection to American workers and their families against the vicissitudes of illness, unemployment and death of a wage earner.

Under the proposed changes, many currently tax-qualified retirement plans will not maintain tax-qualified status, and numerous businesses -- especially small businesses -- will be discouraged from establishing retirement savings plans due to administrative complexity. As a result, the Social Security system may be called upon to provide a greater proportion of retirement security.

In short, employer-provided benefits are efficiently and effectively providing necessary protection for individuals that would otherwise have to be provided by the government -- the very same individuals, taxpayers, who are intended to be helped by tax reform. Imposing new rules and subjecting benefits, such as workers' compensation, health benefits and the untaxed portion of unemployment insurance, to income taxes and payroll taxes for both employees and employers would be contrary to the philosophical underpinnings of the tax reform proposal: simplicity, fairness and economic growth.

II. COMMON MISCONCEPTIONS ABOUT EMPLOYEE BENEFITS

Taxing employee benefits frequently is justified with the assertion that they are only "fringe" benefits for the privileged few. Nothing could be further from the truth. Private employee benefit plans provide benefits to 150 million employees and dependents. Over one million employers are providing retirement and welfare plan benefits. EBRI has documented that almost 95% of all full-time, nonagricultural employees in medium- to large-size firms are provided life, health and disability insurance and that 75% of these employees participate in retirement benefit plans.

Equally important, these benefits are available to a broad range of the work force and are not limited just to the highly paid. Over three-fourths of the employees participating in private pension plans earn less than $25,000. Among employees with vested pension rights, 70% earn less than $25,000; and of employees with health insurance, 80% earn less than $25,000.

Of course, the proposal to tax fully unemployment insurance would affect the families of Americans without jobs and the recommended tax on workers' compensation benefits would likewise affect those in great need.

The overall conclusion one must draw is that employee benefits are important to middle-, low- and no-income families and that proposals to further tax these benefits or provide obstacles to their growth will have a harsh impact on the lives of needy Americans.

Another misconception that fosters efforts further to tax employee benefits is the commonly held notion that the growth of employee benefits as a percentage of overall compensation in recent years means that ever-increasing amounts of benefit payments escape taxation; consequently, employee benefits must now be taxed in order to broaden the tax base. Such a conclusion is erroneous: a review of the statistical data shows that the majority of benefits are taxed already.

The U.S. Chamber's annual Employee Benefits Survey reports that in 1983, 36.6% of the average payroll was spent on employee benefits. However, that figure breaks down as follows: 9% of payroll was the employer's portion of legally required payments such as FICA taxes; payments for time not worked, such as vacations, holidays and sick leave, which were fully taxed, accounted for another 9.4% of payroll; the remaining 18.2% was for benefits that one typically thinks of as employee benefits (e.g., pensions, life and health insurance, lump-sum death benefits.) Much of the value of these benefits, however, such as pension payments, is not tax-exempt but simply tax-deferred. Indeed, EBRI calculates that tax-exempt employee benefits represent only 5% of total wages and salaries.

The move to subject benefits to further taxation, therefore, must be viewed within the context of their current taxation status; and we urge the Committee to do so as we analyze, below, the impact of new forms of taxation on these vital benefits.

III. HEALTH BENEFITS

The proposal to tax the first $10 per month (individual coverage) or $25 per month (family coverage) of health premiums provided by one's employer -- the so-called "tax floor" -- is fraught with problems. It involves serious questions of health policy within the context of tax reform.

Health insurance is designed to make up a loss by restoring a patient's health. It does not add to an individual's personal enrichment. It has traditionally been a principle of tax policy that insured losses do not represent taxable income, and there is no reason to differentiate between loss of property or loss of health.

Moreover, there is no avoiding the fact that a health tax is a new tax on workers that will increase pressures for higher wages to offset the effect of subjecting these benefits to income taxation and payroll taxes. This increased taxation would partially offset any tax break enjoyed by the lower tax rates provided in the Administration's tax proposals. Of particular concern in this regard is the very real likelihood that the $10/$25 per month tax would be only threshold amounts, with the floor continually raised as future Congresses and Administrations search for ways to combat budget deficits.

Taxing heretofore tax-exempt health contributions invariably would induce many workers not to participate in group health plans. EBRI estimates that as many as 10 million Americans would forego health coverage if these benefits became fully taxed. It is easy to understand that many people, especially younger and healthier workers, could decide to give up coverage rather than pay tax on an unused benefit. The adverse results of reduced participation would be twofold.

First, as younger, healthier individuals left plans, the older, less healthy workers and those in higher health-risk job categories would more likely remain. As a result, the costs for coverage of this actuarially at-risk group would skyrocket. Employers would have to pay much higher premiums and, in order to continue group plans, employees would be required to pay a larger share of coinsurance or deductibles.

This would reduce real income for those employees and, no doubt, some of them would no longer participate in health coverage plans. A vicious cycle would ensue with higher premiums being matched by lower participation levels. Some employers, notably small businesses, would be forced to discontinue health coverage altogether, especially as its greater cost was combined with the higher payroll costs associated with subjecting health benefits to FICA and unemployment and payroll-based insurance.

A second and equally unwelcome result of the health tax would be the increased cost to the government to pay for health care for those who went without coverage rather than pay the tax. No humane society allows its citizens to go without medical care, but the nearly universal private coverage would be replaced by increased levels of government-sponsored health care. As mentioned previously, some estimates conclude that the cost for the government to provide the same level of health care provided by the private sector would be three times as much.

Some observers warn of still a different kind of cost incurred by taxing health benefits. Most workers only use their health benefits rarely. Therefore, it is possible that among these workers a tax would increase the demand for unnecessary health treatments as they develop the attitude, "If I have to pay tax on these benefits, I'm going to use them to the fullest!"

Whether health coverage is overused or underused, the concept of relatively low-cost group coverage would be obviated, and both the taxpayer and the Treasury's coffers would be losers.

Quite apart from the general problems with taxing health benefits, the proposed tax floor presents special difficulties. These problems include the following:

1. A tax floor is totally regressive -- all workers with health insurance would pay tax, but the $10 or $25 taxable amount would disproportionately hurt the low-paid.

2. It discourages greater reliance on employee contribution to monthly health insurance premiums, which can be an effective cost containment feature of health plan design. This is the case because additional tax could be avoided by reducing the worker's wages by $10 or $25 per month and having the employer pay that amount toward the health plan in lieu of a like amount of employee contribution.

3. The tax floor is unlikely to raise the predicted revenues because of the avoidance efforts, described in #2 above, that likely would result.

4. The tax floor would be unduly harsh on workers who already make a large after-tax contribution to monthly health insurance premiums and, therefore, would pay tax on a portion of the employer-paid premium in addition to the amount of premium paid by the workers themselves.

Some proponents of a health tax argue that a "tax cap" -- taxing only amounts above a certain employer-provided level -- is advisable. We view this approach as equally undesirable as the "tax floor" since any tax is likely to have a negative impact on the cost and coverage of health benefits.

Some advocates of health benefits taxation insist that the current tax exemption is unfair since some individuals are not covered by employer-sponsored plans and, therefore, must buy insurance with after-tax dollars. However, current tax policy deliberately created this incentive to encourage employee group health plans. Presumably, this was done in recognition of the fact that private health coverage could be provided less expensively than government-paid coverage.

The result of this policy is that the vast majority of workers (96% in large- and medium-size firms) have employer-paid health coverage. In fact, more taxpayers benefit from the health insurance exclusion than from virtually any other tax preference -- including deductions for mortgage interest. Rather than tampering with the health tax exclusion which benefits an overwhelming percentage of Americans because of a perceived unfairness to those who do not enjoy the preference, efforts should be made to extend such vital private health protection to those who remain uncovered.

IV. RETIREMENT SAVINGS

Compared to the other employee benefits elements of the tax proposals, pension and retirement savings provisions appear at first glance relatively unscathed by the proposed changes. But a careful review of these proposals exposes provisions that would have a profound impact on the future of the private pension and retirement savings system.

At the outset it must be unequivocally stated that the pronounced goals of the retirement savings proposals, nondiscrimination in plan coverage and encouragement of savings for actual retirement needs, are laudatory and enjoy the support of the U.S. Chamber. However, the implementation of these provisions likely would have the opposite of the effect desired.

Many of the proposed changes inject further complexity into an already arcane area of law, and the result inevitably will be increased regulatory cost and burdens to comply with new requirements. Even worse, they will cause disincentives for employers to continue providing retirement savings coverage for the nation's work force. This will impose still greater pressure on the Social Security system to meet America's retirement income needs. A review of some of the more significant proposals is in order.

A. 401(k) Plans

Over 20 million American workers participate in 401(k) plans, including nearly one-half million small businesses which offer these plans to their 4.5 million employees. It is an enormously popular and useful program for ensuring adequate levels of retirement income security. The proposed rules regarding participation in 401(k) plans, as well as the proposed elimination of the availability of hardship withdrawals, taxation at ordinary income rates of an employee's withdrawals of after-tax contributions, and imposition of a 20% excise tax for pre-age 59-1/2 withdrawals and a 10% excise tax for post age 59-1/2 withdrawals deemed excessive, would all make such plans less attractive to many employers.

The restrictions on withdrawals are intended to ensure that 401(k) plan contributions are dedicated for retirement security needs. However, the unintended result of such changes would be reduced participation in such plans by lower- and middle-income employees for whom the availability of withdrawing the savings in case of an emergency is essential to participation. It would be an ironic and unfortunate twist of fate if the very same people -- lower-paid employees -- whose interests are most sought to be served by provisions of the tax proposals find that the prescribed practices for 401(k) plans so strictly tie up their savings that they are dissuaded from participation in the programs altogether. As a result, the plans could fail the nondiscrimination participation standards or not be offered at all.

Reducing the 401(k) contribution limit to $8,000 and then further reducing that level by the amount of contributions to an Individual Retirement Account (IRA) not only will make 401(k) plans less popular but also will substantially increase the administrative burden for plan sponsors. Even if the ultimate responsibility for ensuring that combined 401(k) and IRA contributions stay below the minimum limit falls upon individuals, it will involve enormous administrative difficulty for employers to make projections of 401(k) contributions (which may change during a year as compensation levels change) so that their employees will not run afoul of the law. The $8,000 limit, reduced by IRA contributions, also would be especially troublesome for the employees of those businesses in which the 401(k) plan is the only type of retirement program offered.

However, it is the restrictive nature of the proposed participation and withdrawal rules that could sound the death knell for these plans.

Finally, eliminating the availability of 401(k) plan participation for employees of tax-exempt organizations is illogical. If the stated purpose of the existence of 401(k) plans is to encourage savings for retirement years, the tax status of one's employer should not be the factor determining whether one may participate in such a plan. Moreover, the premise upon which 401(k) plan participation is to be denied to employees of tax-exempt organizations -- availability of Tax Sheltered Annuities and Deferred Compensation Plans -- is inaccurate. Tax Sheltered Annuities are not permitted by law for many types of tax-exempt groups, and Deferred Compensation Plans do not contain all the beneficial features of 401(k) plans.

B. Uniform Coverage Rules

Under current law, qualified pension and profit-sharing plans are subject to coverage rules which allow employers flexibility in structuring employee benefits programs while at the same time precluding discriminatory delivery of such benefits. The Administration's tax reform proposal would impose uniform coverage requirements for qualified retirement plans and welfare benefits arrangements as well.

While the purpose of the new rules -- fair and equitable coverage -- is to be applauded, the resulting complexity and greater disincentive for employers to offer retirement and welfare coverage are a matter of real concern.

The application of the uniform coverage rules could lead to the anomalous result that many large companies' plans lose their tax-qualified status even when all workers are covered, simply because all divisions of a control group of companies would be treated as one employer. This problem would be especially pronounced for those companies in multiple lines of business where industry practices provide for different types and levels of employee benefits.

Companies that offer flexible benefit programs designed to meet the particular needs of workers also would be severely hampered because each benefit offered would have to have the proper ratio of higher-paid and lower-paid participants. Thus, a plan that is considered nondiscriminatory one year could run afoul of the rule the next year, simply because not enough lower paid employees elected a certain type of coverage.

As too often happens, small businesses would be inordinately inconvenienced by changes in the law. First, the sheer complexity and cost of implementing new rules would hurt disproportionately smaller firms with fewer resources, thus exacerbating the obstacles already in their paths for providing pension or welfare coverage. Second, a smaller company might find it more difficult to meet the nondiscrimination standards when it has only a few employees, some of whom are high paid and others low paid.

Ultimately, it will be lower-paid individuals who will suffer most -- by the absence of adequate coverage -- rather than the higher-paid individuals who will be better positioned to provide for retirement or welfare coverage needs through alternative means.

The strict and uniform coverage rules are an anathema to a mobile and diverse work force that demands the flexibility of different types of benefits to meet legitimately different needs. The hallmark of nondiscrimination rules should be equality of availability of employee benefit plans to high-, middle- and low-paid workers, not equality of actual participation in a specific plan. Nondiscrimination rules should recognize this so that the private sector delivery of benefits will flourish rather than be constrained.

C. Repeal of Ten-Year Averaging

The proposal to repeal the section of the Internal Revenue Code allowing lump-sum distributions from pension profit-sharing and stock bonus plans to be spread out over ten years, for tax recognition purposes, would impair the value of retirement benefits.

Some plans permit lump-sum distributions rather than life annuity benefits upon an individual's retirement. Currently, such benefits receive favorable tax treatment in that the tax on the benefits need not all be paid at once. This tax treatment is particularly useful for those retirees who use their lump-sum payment for the purchase of some small enterprise or a retirement home that will be important to the individual in his retirement years.

Lump-sum payments especially are frequent when individuals are participants in more than one pension plan, due to employment in different companies. To repeal the ten-year averaging provision will certainly curtail retirees' flexibility and, in many instances, upset individuals' retirement plans contemplated prior to the current tax reform process. In addition, it will cause a considerable hardship for those retirees who, for perfectly legitimate reasons that serve their retirement security needs, elect a lump-sum distribution or who, if a plan is terminated, receive a lump-sum payment.

D. Reversion of Excess Pension Assets

The tax proposal would impose an excise tax upon the amount of assets reverting to a pension plan sponsor upon termination of a defined benefit pension plan. This issue of pension reversions has become a topic of much rhetoric but little understanding.

Certainly no one condones a practice that cheats a worker of his or her earned pension benefits. But the fact that an employer takes back excess assets that it contributed to a pension plan does not mean that pension plan participants are being denied benefits to which they are entitled. Before a company can take back excess assets, upon termination, all participants -- including those not yet vested -- immediately become vested in all benefits accrued to the date of termination. The plan administrator must ensure that all these benefits are guaranteed by assets of the plan -- generally through the purchase of annuities or payment of lump sum benefits.

If companies could not take back excess assets without a heavy tax, they likely would respond by underfunding plans in order to avoid this loss. The result would be detrimental to the stability of the pension system and the people who depend upon it for retirement security. In a sense, the ability of a company to take back its excess contributions to pension plans without a penalty tax is akin to 401(k) plan participants knowing they can withdraw plan contributions, if necessary, without the imposition of a heavy tax. The mere existence of the ability to take back contributions gives both sponsor and participant the confidence and incentive to contribute to such plans without fear that if unforeseen financial circumstances befall them, access to their own resources will be curtailed. Just as we believe that taxing early withdrawals from 401(k) plans will diminish their popularity, taxing pension reversions will cause sponsors to tend toward lower funding of such plans or cessation of defined benefit plans in favor of other kinds of retirement plan for their employees. The excise tax on reversions is a revenue-raising measure that is replete with dire consequences for the pension system.

E. Weakening the Private Retirement System

Many of the retirement savings provisions of the tax proposals will have extensive impact on substantive retirement practices that will weaken the employer-provided retirement system and impose greater responsibilities on the public sector. A number of the retirement provisions have little or no revenue impact on the overall tax proposals and, therefore, represent an effort to rewrite pension policy in the context of tax reform.

Encouraging the use of retirement plans for retirement purposes and ensuring fairness in the coverage of retirement plans are worthy goals. However, tax writers should not overlook the fact that retirement plans also provide vehicles for savings which are vitally necessary for economic growth. Policymakers also must recognize that overly rigid employee benefit plan rules will cause undue cost and administrative burdens to employer and employee alike. This will result in less extensive privately-provided coverage with disproportionate impacts on lower- and middle-income individuals.

V. UNEMPLOYMENT COMPENSATION AND WORKERS' COMPENSATION

Nearly overlooked in the tax reform debate are the proposals to tax workers' compensation (WC) and unemployment insurance (UI) beyond the level at which they currently are taxed. Taxation of these benefits presents special concerns because they are required by law to be provided to employees. Elimination of the tax-favored status of these benefits would alter fundamentally one cornerstone of our long held social policy involving the treatment given and protection awarded to the injured or unemployed worker.

Taxation of all UI and WC benefits will affect adversely both the beneficiaries and the business community. The impact of taxing individuals who are already in financially strained circumstances due to injury or unemployment is obvious. The impact on business is less clear on first glance but equally disadvantageous.

Since the states set benefit levels for both WC and UI, taxation of these benefits by the federal as well as state and local governments (since most state taxation policy mirrors that of the federal government) will require increases in outlays to offset such taxation solely to maintain current, net benefit levels. For example, a recent actuarial study by the National Council on Compensation Insurance projects a 23% cost increase in WC to offset taxation.

Projecting UI payroll tax increases is more difficult because the Congress has twice previously mandated UI tax measures, in one case to raise revenue to fund another jobless pay extension. Currently, UI is taxed if an individual's earnings exceed $12,000 (single) or $18,000 (married). Nevertheless, employer UI payroll taxes will increase as states move to increase benefit levels to offset this additional taxation.

The partial wage replacement nature of both the UI and WC programs would be eroded seriously by further taxation because, by nature, partial wage replacement (and the formulae used by states to determine appropriate benefit levels) includes consideration of the tax-free status of the benefits. Partial wage replacement also provides incentives for both the unemployed or injured worker to return to work at the earliest possible moment.

The federal government has its own WC and UI programs, and benefits under these programs also would face similar outlay increases to maintain current, net benefit levels. The increased benefit levels would be funded through increased payroll taxes in the case of UI and increased premiums in the case of WC. The resulting increased payroll burden will affect an employer's decision to hire additional workers, and this would be especially so for small businesses for whom the payroll tax cost of workers plays a significant role in their employment decisions. Both the UI and WC programs cost employers in excess of $20 billion annually, and increasing the payroll burden on employers (and, in turn, the ultimate costs to consumers of goods and services) will decrease the incentive to expand employment and exacerbate the problems of U.S. firms competing abroad.

VI. CONCLUSION

Few issues have so rallied the business and labor communities in a united stance as the proposals to tax employee benefits. Both realize that imposing new forms of taxation and a wide array of rules on employee benefits plans could be contrary to the worthy goals of tax reform: fairness, simplicity and growth. As this Committee undertakes its critical task of tax reform, it should recognize the success of the private sector employee benefits system and scrutinize the effect of the tax proposals on our current health, retirement and social insurance policies and, accordingly, recognize the concerns of the relevant Congressional Committees that have substantive jurisdiction over these critical policy issues.

WRITTEN STATEMENT BY GARY S. NASH
SECRETARY, CHURCH ALLIANCE

HEARING BEFORE THE SENATE FINANCE COMMITTEE
U. S. SENATE
JULY 19, 1985

My name is Gary S. Nash. I am General Counsel and Corporate Secretary of Annuity Board of the Southern Baptist Convention, 511 North Akard Building, Dallas, Texas 75201. I serve as secretary of the Church Alliance, an alliance of the chief executive officers of the church pension boards of 28 religious denominations acting on behalf of the pension programs of the Catholic, Protestant, Jewish and other faiths represented.

The Church Alliance members appreciate the opportunity to submit this written statement on behalf of participants in church plans to the Committee. Our statement comments on the President's Tax Proposals to the Congress for Fairness, Growth and Simplicity of May 1985 affecting retirement benefits provided by church pension boards to participants in church plans.

SUMMARY

Many church denominations in this country provide retirement benefits for their ministers and denominational employees through church plans administered and funded through church pension boards. Many of these church plans are established as retirement income account plans under Section 403(b)(9) of the Internal Revenue Code. The vast majority of the participants in these plans are middle and lower-income taxpayers. The funding for these plans is from contributions made directly by the employer or by voluntary salary reduction or both.

We are concerned that the following portions of the President's Tax Proposals, unless modified or rejected, would decrease the opportunities the clergy and denominational employees have to retire with adequate retirement income: (1) the repeal of the special "catch up" elections of Section 415(c)(4) and 415(c)(7); (2) the prohibition of early distributions absent separation from service, the attainment of age 59-1/2, death, or disability and the imposition of an excise tax (ordinarily 20 percent) on any distribution amounts which could be received before age 59-1/2; (3) the application of the rules for unfunded deferred compensation plans in Section 457 (for state employees) to employees of tax exempt organizations, including churches and church organizations.

DISCUSSION OF AREAS OF CONCERN

The President's Tax Proposals with respect to retirement plans are intended to eliminate complexity and achieve greater uniformity. Although these proposals would have a minimal revenue impact and are not tied to rate reduction, we are concerned that the enactment of these proposals will severely impair the ability of denominational employers and employees to provide a decent retirement income for such employees and their families. Historically and today most of the employees in the religious non-profit sector will continue to be lower paid and have less access to a broad selection of retirement plans than corporate employees. The existing laws governing Section 403(b)(9) retirement income accounts (referred to as tax sheltered annuities in the President's Tax Proposals) are working well.

CONTRIBUTION LIMITS - REPEAL OF SPECIAL ELECTIONS (Chapter 14.04, page 358 of the President's Tax Proposals)

The contributions limits presently applied to retirement income accounts are no more generous than the contribution limits for qualified plans.

From 1958 until 1974 the tax law was simple in this area -- only the "exclusion allowance" of Section 403(b)(2) governed the tax deferred contributions to a Section 403(b) annuity. The "exclusion allowance" inherently allows for catch-up contributions since two of the factors in the calculation are years of service and prior excluded contributions.

In 1974, "ERISA" (the Employee Retirement Income Security Act of 1974) superimposed on the exclusion allowance a 25-percent-$25,000 limitation. (Today, the dollar limitation is $30,000.) Although the 25-percent limitation permits catch-up contributions for the well-compensated participant, it does not for the poorly paid participant. Obviously, 25 percent of $100,000 of compensation is not a stringent limitation, but 25-percent of $20,000 is stringent if catch-up is necessary.

Congress recognized this point and included in the 1974 tax law the special elections of Section 415(c)(4) for several classes of traditionally poorly compensated employees, other than denominational employees. Two of the special elections (the "(A)" and "(B)" elections) permit catch-up. The "(C)" election allows a participant to disregard the computation of the Section 403(b) exclusion allowance and elect the application of the 25-percent-$30,000 limitation. In 1982, Congress extended the special elections to participants in church plans and added a "$10,000" election for church plans. The Church Alliance had proposed a "$15,000" election; however, the "$10,000" election was added to the Code as a result of a legislative compromise.

Ministers and lay denominational employees need the special elections because they typically begin their careers on very modest salaries and are usually not able to accumulate adequate annuity funding until late in life. For example, the clergyman who starts out with a salary of $10,000 - employer annuity contributions will be a function of salary and thus small. The minister will have to use his salary to sustain his family and educate his children, and he will not, from his own resources, be able to make any contributions for many years. At a point in his career, living expenses may decrease, and he may have a chance to make contributions to his retirement income account. However, this minister will be prohibited from making any meaningful contributions by the imposition of the 25-percent-of-compensation limitation because his salary is still not very large.

The Church Alliance testified on our need for the special elections and on other matters on December 4, 1979, at a hearing before the Subcommittee on Private Pension Plans and Employee Fringe Benefits of the Committee on Finance. The Church Alliance also testified on May 19, 1982, before the Finance Committee's Subcommittee on Savings, Pensions, and Investment Policy. At this hearing, Mr. David Glickman, as U.S. Treasury Deputy Assistant for Tax Policy, supported the extension of the special elections to church employees and the $10,000 election as finally modified. We note the statement of Senator Lloyd Bentsen, sponsor, in support of S.1910 at the May 19, 1982, hearing.

While we have had but two years of experience with the special elections, we find that the "(B)" and "$10,000" elections have been put to much use by church employees. In one denomination, 665 ministers and lay employees in 1984 contributed to a program that supplements their retirement annuities from employer contributions. Of these, 150 used the "(B)" election in combination with the "$10,000" election. Several examples of those who used the special elections are enclosed. Another denomination states that of the 6,500 members in its plan, about one-third makes additional contributions through the "(B)" election to a supplementary retirement program. These individuals are from age 55 to 65 and would have a pension of $7,000 - $8,000 a year if they retired now. They could not make these additions except through use of the special elections. Another denomination estimates that five percent of all members and ten percent of those between age 55 and 65 use the special elections. This demoninations gives the example of one retiree this year of age 65 with 42 years of service as a minister and a final salary of $18,000. With additional contributions his pension is $11,928; otherwise it would have been $11,040. This denomination confirms that the elections are quite valuable, in particular the "(B)" and $10,000 elections. Since the "(A)" election is used only in the year of separation from service, we have not yet had much experience with it. Our figures indicate that for church employees several uses of the "(B)" and "$10,000" elections are theoretically more valuable for church employees than a one-time use of the "(A)" election.

The special elections are complex, to be sure. Nevertheless, the Church Alliance has developed our own worksheet that coordinates the special elections with the exclusion allowances of Section 403(b)(2), and we are familiar with the calculations. Some denominations have computer-programmed the worksheet and are able to calculate contribution limitations with little effort.

It should be noted that the proposed elimination of the special elections for participants in church plans would increase government revenues in a minimal way and yet will impair the ability of participants in church plans to achieve decent retirement incomes.

Although the exclusion allowance of Section 403(b)(2) has a built-in catch up feature which was designed to allow lower paid employees in the non-profit sector to make catch-up contributions in their retirement annuities, the superimposition of the 25-percent limitation eliminated this catch-up feature for the great majority of denominational employees -- but for the special elections.

We contend that it is less fair to eliminate the special elections and still retain the 25-percent limitation. If the special elections are to be eliminated to achieve simplicity, then we would recommend that the 25-percent limitation of Section 415(c)(1)(B) be removed from applying to Section 403(b)(9) retirement income accounts. These accounts would still be governed by both the dollar limitation ($30,000) of Section 415 and the exclusion alowance of Section 403(b); this would allow reasonable catch-up opportunities for those participants who are unable to make significant 403(b) contributions during the early years of their careers.

DISTRIBUTION RESTRICTIONS AND EXCISE TAX (Chapter 14.02 of the President's Tax Proposals)

We support the President's Tax Proposal to remove the doctrine of constructive receipt from applying to 403(b) plans -- as it has already been removed from applying to 401(a) plans. The President's Tax Proposals would impose minimum distribution rules on all tax-favored plans. However, we are concerned that the President's Proposal would add especially strict rules to all tax-sheltered annuities, including retirement income accounts. Financial hardship would be eliminated as an event permitting distribution. Early distributions from tax-sheltered annuities are "prohibited" absent separation from service, the attainment of age 59-1/2, death, or disability. There are no similar restrictions for Section 401(a) plans. Not only is an early distribution from a retirement income account generally prohibited, but an early distribution made on account of separation from service would be subject to an excise tax of 20-percent (lowered to 10-percent in certain cases).

We are concerned that prohibitions against, and harsh confiscatory penalties for, early distributions will inhibit retirement plan contributions being made for our ministers and lay employees. Today only a small percentage of the accumulations in retirement income accounts are actually withdrawn prior to retirement.

We believe that inflexible and harsh rules restricting distributions will have the effect of discouraging retirement savings. Furthermore, an excise tax unfairly penalizes lower and middle income taxpayers. Wealthy taxpayers are not as adversely affected by an excise tax on early distribution.

UNIFIED RULES FOR UNFUNDED DEFERRED COMPENSATION ARRANGEMENTS (Chapter 14.10, page 379 of the President's Tax Proposals)

The President's Tax Proposals would, with changes, apply the rules for unfunded deferred compensation plans in Section

457 to employees of tax-exempt employers, including churches and church organizations. We feel this proposal is unfair, and it is certainly not uniform. No similar rules are contained in the President's Tax Proposals concerning taxable employers.

Although unfunded deferred compensation agreements are not common in church organizations, the President's proposal in this area would severely limit church and other non-profit employer's ability to deal with special situations through elective unfunded arrangements. At times a minister will work for a church organization upon the condition the organization will supplement his retirement income. This arrangement would not be subject to Section 457 as proposed because no compensation was deferred. However, the arrangement is always subject to the inquiry whether the minister would have received more compensation if the organization had not promised to supplement his retirement income.

Since contributions to elective unfunded deferred compensation arrangements would be coordinated with contributions to retirement income accounts under Section 403(b)(9), employers using 403(b) plans would be penalized by the limitation on their ability to provide supplemental benefits through elective unfunded arrangements. We note that taxable entities may establish unfunded deferred compensation plans at will without any coordination with their Section 401(a) plans.

The Church Alliance would prefer that church employees not be subject to Section 457. The fact that most employees of nonprofit organizations receive below market salaries and that nonprofit organizations are subject to the tax rules which prohibit private inurement serve as a safeguard against the proliferation of unfunded deferred compensation agreements for church employees.

The proposed application of Section 457 to church plan participants as well as the proposed coordination of contributions to Section 457 with contributions to retirement income accounts is harsh, grossly unfair and an attack on denominations that use Section 403(b)(9) retirement income accounts. This proposed application, coupled with the proposal to eliminate the special elections, and impose distribution restrictions will thwart the ability of participants in church plans to receive adequate retirement incomes.

STATEMENT FOR THE RECORD

BY TAD WIDBY, PRESIDENT
COMMUTER TRANSPORTATION SERVICES, INC.
LOS ANGELES, CALIFORNIA

SUBMITTED TO THE
COMMITTEE ON FINANCE
U.S. SENATE

FOR THE RECORD OF HEARINGS ON
THE PRESIDENT'S PROPOSAL FOR TAX REFORM

JULY 1985

Commuter Transportation Services, Inc. is a private, non-profit company founded in 1974 and serving Southern California employers, employees and commuters.

Our mission is:

> "Through a partnership of business, government, individual action, we are responsible for applying the best human, technological, and other resources to make the commute easier, more convenient and less costly".

ABOUT RIDESHARING

-- More than 250,000 commuters are registered with Commuter Computer.
Over 67,000 individuals are currently sharing rides as a result of registering with us, or learning indirectly about our service through other ridesharers.
An individual ridesharer can save between $500 and $2000 annually in gas, vehicle wear and tear, parking and related transportation expenses (based on 1984 Federal Highway Administration estimates).

-- Over 162,000 individuals have been served by Commuter Computer.
Ridesharers have saved approximately $219 million in transportation costs.
Ridesharers have saved about 71.3 million gallons of gas.

Ridesharing and alternative transportation modes are the most cost-effective means of easing traffic congestion on our existing highway system.

Few incentives exist today to assist employers and employees in establishing employee transportation programs and those that do exist are in jeopardy.

Under the Tax Reform Act of 1984 transit subsidies provided to an employee by an employer may now be treated as taxable income to the employee on their federal tax returns. This act mandates:

a. any transit pass (and probably any ridesharing subsidy) in excess of $15.00 per month be treated as taxable income to the employee.

b. that vanpool benefits will no longer be tax exempt in a cafeteria type approach to employee benefits.

c. benefits from free parking are exempt from income taxation to employees.

This change in the taxable status of employer-provided commute benefits is causing employers to change their views of employee transportation assistance. The result is a step backward toward greater dependence on driving alone. This will cause more air pollution, higher demand for new roadway capacity, and more energy consumption. We do not believe this discrimination in favor of auto parking is reasonable.

The fiscal impact on the federal deficit of taxing ridesharing subsidies would be minimal. However, the fringe benefit provided to an employee by means of a subsidized bus pass or vanpool benefit can mean the difference between an individual driving alone or sharing a ride.

Commuter Transportations Services, Inc. asks that you consider these issues during hearings on any future tax reform bill.

STATEMENT OF THE
DELTA DENTAL PLANS ASSOCIATION
TO THE
COMMITTEE ON FINANCE
UNITED STATES SENATE
JULY 19, 1985

Mr. Chairman, I am Patrick P. Gribben, Jr., President of Delta Dental Plan of Michigan and President of Delta Dental Plans Association. Delta Dental Plans Association is the national coordinating agency for the country's not-for-profit dental service organizations.

We appreciate the opportunity to testify and want to say at the outset that we believe that the existing tax incentives for health care benefits are responsible for a system that is fundamentally fair and that has ensured that the average employee has adequate health care coverage. Moreover, we believe that any change in the tax treatment of these benefits could cause a serious diminution of the health care benefits of a large number of employees and their families.

Delta Dental Plans are separate, autonomous prepayment organizations under the jurisdiction or regulation of state insurance commissioners or attorneys general. As a result of Delta's support by the dental profession and unique contractual relationships with participating dental practitioners, Delta Dental Plans provide true "service" benefits, in contrast to indemnity payments, for the cost of treatment to covered subscribers.

An estimated 70,000 dentists, over two-thirds of the approximately 100,000 active practitioners in the United States, are presently contracting participants in Delta programs.

Delta Dental Plans design their programs to provide maximum dental care benefits to subscribers at reasonable cost to the program purchaser and the covered subscriber. Since all Delta Plans are not-for-profit, no portion of the benefit dollar is held for dividends to shareholders. All funds received by Delta Plans, therefore, are used to pay for services rendered to covered subscribers and eligible dependents and the administration of the program. Dental consultants are designated by the Plans to review the necessity, appropriateness and adequacy of care provided by participating dentists.

Delta Plan administrative techniques, which have evolved from a first-hand awareness of the "elective" nature of most dental treatment, embody a cost containment concept most visible in such program design elements as deductibles, copayments and maximums, and in the determination of covered benefits by Plan dental directors and consultants. Basing their claims processing policies on professionally accepted standards of dental care, Dental Plan dental directors and consultants are able to effectively control areas of program over-utilization and other potential abuses.

Dental disease is the most extensive health problem in the United States today, and is almost pandemic with respect to its occurrence in the population. Dental diseases are not self-healing and cannot be cured by professional advice or medication alone. Without treatment, dental diseases continue their damage and proceed to become more severe. Some oral health problems have become so widespread that many people have accepted tooth loss and other complications of dental disease as inevitable.

A major difference between the public's view of medical and dental payments is that all too often people fail to relate oral disease to their general systemic health and well-being. Frequently there is a tendency to accept dental disease complacently because of the undramatic nature of most dental problems in their early stages. This casual acceptance of dental disease contributes greatly to the postponement of treatment.

Although the cumulative dental health problems of this nation are huge, remarkable progress can be made, and has been made, if the existing knowledge and science of dental treatment are put to use and made available to our citizens. The most economic and efficient way to improve the nation's oral health is to prevent dental disease. From the economic standpoint, regular and routine preventive care and maintenance is the most cost-effective and efficient way to overcome both the human suffering and the hours of productive work time lost through the disabilities caused by the poor oral health of countless millions of Americans.

In recent years it has become widely accepted by health care professionals and economists that prevention might be used, not only to improve the health of Americans, but also to help contain the cost of their health care.

The basic idea is a simple one: relatively low cost investments in disease prevention and health education will prevent or postpone the onset of illness and disability requiring more expensive treatment. Thus, prevention succeeds as a cost containment mechanism if the dollars saved in future years exceed the current cost of the prevention effort, whether the savings are due to expenditures completely avoided or only delayed.

The experience of recent years in dental care through programs of preventive treatment and the mechanism of dental prepayment and insurance has been perhaps the most dramatic example of the principle of prevention in action.

Once thought "uninsurable," dental care has now joined hospital and medical/surgical coverage as a standard benefit in the employee benefit package in virtually all segments of the American work force. Dental prepayment has enabled and/or motivated a fair number of people to obtain dental care than would otherwise have been possible. It is a demonstrated fact that a larger proportion of covered patients regularly seek dental care than do those without dental benefit programs.

Less than 20 years ago, nearly 65 percent of the population did not visit the dentist during a given year. Today, more than half of the population has one or more dental visits annually. Two factors have been critical to this improved picture: the emphasis on preventive measures, health care education and early diagnosis and treatment in the dental office and the growth of prepaid dental benefit programs to the point where over 100 million Americans have dental care coverage today.

This expanded coverage has been made possible by the current tax policy toward health care benefits. The existing tax incentives for employer provided health care benefits must be continued, in our judgment, if this pattern of improved health is to continue.

When the Administration initially proposed placing a "cap" on the deductibility of employer-paid health care benefits, Delta opposed it for two reasons: The results of a survey by the Roper Organizations and commissioned by Delta showed that, in the event of a "cap" on the tax-exempt status of their health benefits, 76% of the respondents were likely to drop some parts of their health coverage. We believed also that a tax on health care benefits was fundamentally unfair. We opposed it as matter of principle and that continues to be our position.

In tax proposals submitted to the Congress in May of this year, the President suggests that the first $10 per month for an individual and $25 per month for a family of employer-provided health insurance benefits should be taxed. He argues that employer-provided health care benefits are unfair to individuals who are not covered by employer plans and therefore have to pay for health care with after-tax dollars. In our judgment, the President is pushing down on the wrong side of the scale in an attempt to equalize the benefit of comprehensive health care coverage. Instead of discouraging the provision of health care benefits by taxing them, the President should be encouraging those who do not now have adequate health care coverage to get it.

This last point is one we believe should be of vital concern to this committee, Mr. Chairman. With minimal encouragement, the working men and women of this country can receive comprehensive health care benefits and we are a better nation because of it.

Certainly, employer-provided health care benefits serve significant social policy objectives that would otherwise fall to government and government-funded programs. A tax on these benefits, even a small tax, would have long-term adverse consequences on the health care protection of the American people. We urge the Committee to reject this proposed tax on health care benefits and not to change those incentives that are fundamentally fair and fundamentally sound in their effect.

Thank you.

WRITTEN STATEMENT OF THE EDISON ELECTRIC INSTITUTE ON EMPLOYEE BENEFITS

The Edison Electric Institute (EEI) is pleased to have the opportunity to present a written statement for the printed record of the July 19, 1985, hearing before the Committee on Finance, U.S. Senate, on "the projected impact the tax plan will have on employee benefit programs."

EEI is the association of electric companies whose members employ some 600,000 persons and serve 96 percent of all customers served by the investor-owned segment of the industry. They generate approximately 75 percent of all electricity in the country and provide electric service to 73 percent of the nation's consumers.

The portion of the President's proposals that would change the tax treatment of many employee benefits is a major concern to the electric utility industry and its employees. These proposals, if enacted, could result in a significant decrease in participation in employee benefit plans among employees in the lower and middle income levels. Our industry, like most others in the United States, has established employee benefit plans as a supplement to direct compensation to help our employees plan for their retirement security and to provide them with insurance in the event of their or their dependents' illness or disability. These benefit plans were established in good faith in accordance with the provisions of the Internal Revenue Code and other rulings from the Internal Revenue Service. Since 1982, three major pieces of legislation have been passed that have disrupted the stability of the private sector system of employee benefits, and have, in some respects, begun to erode the foundation of the private pension system. Now, the President's proposals pose a further threat to this important private sector mechanism of providing security to our employees, with the potential result of an increased demand on the federal government for retirement and health benefits.

For example, there are a number of proposals that would dramatically affect the tax treatment of retirement savings plans. Virtually all of the companies that are members of the Edison Electric Institute have established retirement savings plans to supplement the tax-qualified defined benefit pension plan. These savings plans were made available to employees in support of the concept that has come to be known as the "three-legged stool" of retirement security. This concept holds that, in order for a retiree in the United States to be assured of adequate income during his or her retirement years, income will normally come from three sources: private pension plans, social security, and the individual's savings. It is through the qualified retirement savings plan that the third component of the three-legged stool - individual savings - is most often provided. According to one leading employee benefit research organization, 29% of Americans do not set aside any savings for their retirement other than what is provided by their employer. Company-sponsored qualified retirement savings plans have provided most of the incentive that does exist for individual savings in this country. In our own industry, we have seen a dramatic increase in employee participation in retirement savings plans over the past few years.

However, various proposals would limit the attractiveness of these company-sponsored plans to rank-and-file employees. Severe excise taxes are proposed for virtually all plan withdrawals, and favorable tax treatment of lump-sum distributions in the form of ten-year-forward averaging is to be eliminated completely. One type of retirement savings plan that has become increasingly popular over the past few years, the 401(k) plan, would be severely limited by strict discrimination tests, a virtual prohibition on withdrawals without severe penalties, and an offset of allowable contributions by participation in an Individual Retirement Account. As we indicated earlier, these proposals, if enacted, could result in a significant decrease in participation among employees in the lower and middle income levels, because they would rather not contribute to a plan that provides virtually no opportunity for withdrawal in the event of an emergency, and which does not offer attractive benefits at retirement in the event that they want to receive their savings as a lump-sum distribution. Unfortunately, employees who discontinue their participation in a company-sponsored retirement savings plan may not set aside adequate savings for retirement through other vehicles. As a result, these persons could depend more upon the federal government at retirement age for increased social security benefits or other government-sponsored programs. We believe that sound national policy should encourage saving for retirement, not discourage it.

Another proposal of particular concern to us is the proposed taxation of health insurance benefits. The system of employer-provided health insurance is another example of a private sector initiative totally sanctioned by existing tax law and which, if curtailed or discontinued, would result in increased dependence upon the federal government for benefits. Some have argued that the proposed levels of taxation - $10 per month for individuals and $25 per month for families - are too low to create a hardship for most workers. However, we are concerned that these limits would be subject to repeated increases in future years - just as recent legislation has continually reduced the amount of allowable retirement benefits - so that ultimately the entire health benefit could be counted as taxable income. We believe that the imposition of a tax on this benefit in any amount is an undesirable precedent that should not be established.

The costs and administrative requirements that have resulted from the passage of recent legislation have made it extremely difficult for our companies to provide benefits to employees with any degree of continuity. This creates confusion for our employees and leads to waste and inefficiency. We believe that the proposed changes in law that would affect employee benefits would have an additional negative impact on the efficient and cost-effective administration of our plans. More importantly, employees have been making investment, savings, and retirement planning decisions over their working careers based upon the assumptions that existing laws would be in effect indefinitely. To change these laws as has been proposed would be unfair to employees and would make it extremely difficult for them to adequately plan for their security after retirement. Further, any proposals to change the laws governing employee benefits should be considered within the context of the potentially damaging effect that such changes could have on the private sector's system of employee benefits that has worked so well over the past several decades.

Attached is a copy of the relevant portion of our testimony presented to the Ways and Means Committee on July 25, 1985. The Edison Electric Institute appreciates the opportunity to comment on this important issue.

EMPLOYEE BENEFITS

Mr. Chairman, EEI will submit a separate statement for the record on the subject of employee benefits, which will detail our position on the President's proposals. The following summarizes our concerns in this area.

Overall Comment

During the last few years, so many changes have been enacted in the area of retirement and other employee benefit plans that there is much confusion on the part of employees, employers, and the Internal Revenue Service as to what actually is required for plans today. Another wholesale revamping of such plans, as would be necessary under the President's proposals, would, of course, create even more confusion. More importantly, employees have been making investment, savings, and retirement decisions over their working careers based on a set of favorable provisions in the law. To change them now, as extensively as the President proposes, would be both unfair and harmful to the employees who, in making those decisions, have relied upon the more favorable provisions in the Code at such time.

Qualified Plans

The proposed limitations on qualified plan contributions and benefits and the plan limitations prescribed by the new non-discrimination tests would cause the disqualification of many employees. We believe that some features of the proposals would so hamper efforts of both employers and employees to provide for adequate retirement funds that sufficient retirement income would become less attainable through private plans and the burden on government could increase significantly.

Contributions to Section 401(k) Plans

The proposed annual $8,000 cap on the amount of an employee's contribution to a qualified cash or deferred arrangement would be unrealistically low for many employees. Any cap should be expressed as a percentage of income to provide all employees an equal opportunity to have supplemental retirement income in proportion to their earnings. Further, the inclusion of IRA contributions in arriving at a cap would be unworkable when applied at the employer level.

Early Withdrawal Penalties

Excise tax penalties on benefits paid under qualified retirement plans prior to attaining age 59-1/2 in many instances would deter employees from retiring at an earlier age even though they are permitted to under the rules of their retirement plan. Equity dictates that excise taxes not apply to any payment from a qualified plan by reason of retirement at any age because to preclude an employee from retiring by means of an excise-tax penalty takes away the employee's right to determine his or her own retirement date.

Lump-Sum Distributions

Ten-year averaging for lump-sum distributions from qualified plans provides a vital means for a majority of employees to make their own decision as to how they want to use the savings that they accumulated during their working career. Higher-paid employees, for the most part, will utilize a rollover to an IRA, but ten-year averaging still should be permitted for distributions to more modestly paid employees. If ten-year averaging is repealed, then amounts allocated to employees prior to the enactment of the repeal should be "grandfathered."

Employer-Provided Health-Care Benefits

The existence of employer-provided health-care benefits is an example of a privately sponsored program that decreases the dependence upon governmental assistance for providing health care. We believe that imposition of the income tax on employer-provided health-care benefits would set a dangerous precedent and could discourage employees from participating in such programs. Many employees might drop out of employer-sponsored medical programs, which would place the burden of providing their health-care benefits on federally funded programs. This would not be in the best interest of either employees or the government.

PETER GOULD
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1985 JUL

June 26, 1985

Ms. Betty Scott-Boom
Committee on Finance, Room SD-219
Dirksen Senate Office Building
Washington, D.C. 20510

Re: Written Statement for Inclusion in the Printed Hearing
Records of the Senate Finance Committee Regarding Tax Reform

Dear Ms. Scott-Boom:

This letter is being written to express my concern about certain provisions of the recently-issued tax reform proposals. I am an Employee Benefit Consultant and my firm specializes in the design and administration of qualified retirement plans. The majority of my clients are small businesses - the industries represented by my clientele include: Trucking Firms, A Dairy, Hardware Stores, Swimming Pool Builders, Physicians, Insurance Agencies, and Professional Builders. The "average" plan (if there is such a thing) covers approximately ten employees. As you can see, my clients have demonstrated their support of the private pension system in the United States by establishing and maintaining qualified retirement plans for their employees.

As you know, three major peices of pension legislation have been enacted in the past three years - the Tax Equity and Fiscal Responsibility Act of 1982, the Tax Reform Act of 1984 and the Retirement Equity Act of 1984. As a result of these laws, each of my clients has incurred the expense of amending and restating its existing retirement program to comply with the new laws. Although I attempt to provide the highest quality services at reasonable prices, the process of amending and restating a qualified retirement plan and resubmitting the plan to the Internal Revenue Service for approval is substantial. The average fee for this service generally equals or exceeds the clients' annual plan administration expenses. As you can imagine, the going rates for amending and restating plans to comply with the new laws are much higher in major metropolitan areas.

It was with great interest that I reviewed the annual Social Security Trustee's reports which were released in March, 1985. It is alarming to note the projected deficits in the Social Security System as projected for the next 75 years. In light of these projections, it would seem appropriate to encourage employers to maintain and establish retirement plans!

The three pension laws (mentioned above) did not do much to encourage the private pension system. They have increased retirement plan administration expenses for every plan and they have caused employers to incur substantial expenses in amending their plans to comply with the new laws. I do not take issue with the concepts contained in TEFRA regarding minimum plan contributions and benefits, minimum vesting, etc. nor do I take issue with the spousal protections contained in REA (despite the additional expense). It would seem that some of these objectives could be met in a simpler and more objective manner. For instance, under ERISA, if a participant in a defined contribution plan does not complete 1,000 hours of service, the participant is not entitled to receive an employer contribution. For some reason, this 1,000 hour rule has been maintained (by TEFRA) for defined benefit plans but it has been eliminated for defined contribution plans. It seems to me that this rule should be reestablished for defined contribution plans to simplify the administration of such plans. Based upon my estimates, the number of participants who would be deprived of a contribution (under the pre TEFRA rules) would be less than 5%.

The entire concept of "top heavy plans" is especially troublesome to me and my clients. What TEFRA has done is establish a higher and more costly standard for retirement plans maintained by small businesses than for plans maintained by larger businesses. My clients with small businesses (with top-heavy plans) cannot fathom why the huge and profitable corporations of this country are not subjected to TEFRA's minimum benefit and contribution rules, accellerated vesting rules, etc. They are extremely distressed by the new premature distribution penalties imposed by TEFRA on business owners. If these small business owners were employed by a large bank or manufacturing company they would be permitted to retire at age 55 without penalty! It seems extremely inequitable to subject them to a penalty for retiring at that age after they have undertaken the risk and years of hard work to establish their own small businesses.

A cursory review of the new tax reform proposals (affecting qualified retirement plans) leads one to the impression that every change will be a negative one for the small business owner who has established a retirement plan. Among these offensive proposals are the following: "castration" of 401(k) plans, new coverage requirements for qualified plans, the elimination of favorable tax treatment for lump-sum distributions from qualified plans, the unfavorable tax treatment of distributions of employee contributions, the stricter premature distribution penalty, the harsher restrictions on participant loans, further changes and reductions in the deduction limits for qualified plans, additional limits on the contributions and benefits of plans and the proposed excise tax on reversions of terminated plan assets.

Ms. Scott-Boom, I sincerely hope that you and the members of the Committee on Finance will give serious consideration to the items mentioned in this letter. Although the views expressed are those of my firm, I feel that they are representative of most small businesses who maintain qualified retirement plans. To encourage the health and growth of the private pension system, you must provide positive incentives to the employers that establish qualified retirement plans and to the participants in those plans. Unfortunately, much of the recent legislation in this area has had the effect of eroding these incentives. You and the members of the Committee on Finance hold the future of the private pension system of the United States in your hands.

Yours truly,

Peter Gould

Peter Gould
Employee Benefit Consultant

PG:lb

STATEMENT ON BEHALF OF THE GROUP LEGAL SERVICES COALITION

by

Alec M. Schwartz
Executive Director
American Prepaid Legal Services Institute

and

William A. Bolger
Executive Director
National Resource Center for Consumers of Legal Services

Before the

COMMITTEE ON FINANCE

UNITED STATES SENATE

On the Subject of

THE TAX TREATMENT OF QUALIFIED GROUP LEGAL SERVICE PLANS

July 19, 1985

STATEMENT

Mr. Chairman:

The Group Legal Services Coalition supports the recommendation in the President's proposals for comprehensive tax reform to make permanent the present tax treatment of qualified group legal services plans under I.R.C. section 120.

The Group Legal Services Coalition is coordinated by the American Prepaid Legal Services Institute and the National Resource Center for Consumers of Legal Services, two non-profit membership organizations whose members serve millions of employees covered under employer-paid group legal services plans. Our members include the largest and most highly developed group legal plans in the nation, many smaller plans, and a large cross-section of the insurers, administrators, plan trustees, lawyers and consumer groups active in the field.

Section 120 excludes from the gross income of an employee both contributions made by an employer to such a qualified group legal services plan and the value of any legal services received by the employee under the plan. There are four reasons why the Group Legal Services Coalition has supported this tax treatment of employer-paid legal plans and why we feel that section 120 should be made permanent now, as proposed by the President:

1. Group legal services plans have proven their ability to deliver high-quality legal services at low cost. They are especially effective at making preventive legal care available -- those basic legal services which put an individual in a position to resolve legal problems early on, thereby avoiding expensive and time-consuming remedial services later.

2. Because of their demonstrated effectiveness, group legal services plans are supported by the labor and consumer movements, the legal profession and the insurance industry. There is no opposition to these plans, which have been developed in the best American tradition of pragmatic, voluntary, private-sector action to meet a demonstrated societal need.

3. Congress has a strong, consistent record of support for making legal services available to employees, beginning in 1973 with an amendment to section 302(c) of the Taft-Hartley Act, continuing in ERISA in 1974, then in enacting section 120 in 1976, extending it in 1981 and again last year.

4. Section 120 has proven its effectiveness in stimulating the growth of legal services plans at minimal cost in foregone tax revenue. Approximately 13

> million Americans are presently covered by a plan, the largest portion of these under employer-paid plans, yet the revenue loss this year will be just $32 million, according to the Joint Committee on Taxation.

Let's look briefly at what these plans are and whom they affect. Plans exist in every region of the country. They cover the basic legal service needs of middle-income families in every state in the Union. They affect young workers as well as retirees. Their beneficiaries are public school teachers, construction laborers, police officers, service employees, municipal workers, office and technical employees, truck drivers, skilled craftsworkers -- the working people of America and their families.

The legal services provided by these plans are those most often needed by the average citizen -- legal advice: answers to those little questions you know you should ask a lawyer but which you never get around to asking; help with making a will, getting a divorce, dealing with a complex apartment lease, buying your first house, getting your TV repaired properly under warranty, using small claims court to settle minor disputes, adopting a child or assuring that the life savings of aged parents are protected, exercising your rights in traffic court and getting fair treatment for a daughter or son who has been accused of a "slight" transgression by the school authorities. Many legal plans go further, providing legal counsel in criminal and civil court actions, assistance with bankruptcy and representation before administrative agencies.

How common are these problems and do legal plan benefits really help? A comprehensive survey of the legal needs of the public published in 1977 by the American Bar Foundation and carried out by the National Opinion Research Center indicated that more than 35% of the population encounter problems each year that could be resolved by a lawyer, yet only 10% actually seek legal assistance. In contrast, our information indicates that an average of 20% of the employees covered by a group legal plan consult a lawyer at least once annually.

But the best way to get an idea of the benefits that accrue to employees who have access to justice through a legal plan is to hear directly from them:

Talking about a family dispute over the transfer of the family home,

> "...Thanks to the legal services plan of Local 25 and the excellent work of (the plan's attorney), we're still in our house, my mother's wishes were followed, and justice was done. Without the plan, we probably would have lost

the house even if we had fought against the fraud...."

-- Joseph Ruth of Washington, D.C. testifying before Congress last year.

From a worker in Buffalo, New York,

"I feel that this (legal services) program allows a person to pursue legal remedies to problems that would be financially prohibitive under most circumstances. We are no longer at the mercy of those who can easily afford an attorney!"

From Tennessee:

"I think UAW and GM did a wonderful thing when they set up this Legal Services (plan) because some of us are just not able to pay what the attorneys charge today. We have used this program twice and it has saved us money, and provided complete information and assistance."

And a Michigan retiree wrote:

"I believe the UAW-GM Legal Services Plan provides a vital service to retirees, who otherwise would not be able to afford even such a small item as a common will. This Plan is also a Godsend to the total and permanent disabled..."

These employee-users are in most cases receiving preventive legal assistance that often makes it possible to avoid litigation or other serious, protracted remedial services. Some of the newest prepaid legal plans feature legal advice and consultation by telephone. The administrators of these plans have told us that between 60% and 80% of the problems presented by plan members can be resolved over the phone in one or two calls or with telephone negotiation with adverse parties. By making legal counseling available conveniently, often by telephone, employees are encouraged to consult a lawyer at the outset of a potential legal problem. Without timely legal help, problems which might have been easily resolved can end up with the employee in court, rather than on the job.

We believe that legal services plans, with this emphasis on preventive legal help, have a direct economic impact on employers and the general economy as well. To illustrate, let's take a "minor" matter which actually occurred in a midwest office.

An employee had been repeatedly billed by a hospital for approximately $130 which he thought he didn't owe and which he had no money to pay in any event. Repeated requests for payment were ignored until the employee received a summons from county court located 35 miles away from the office. The employee mentioned the need to take time out from work to go to court to his supervisor, who advised that the employee talk to a lawyer first. A lawyer was consulted and eventually accompanied the employee to court twice, requiring the employee to be absent from work for one-half day each time. As a result, a settlement with payment arrangements was worked out with the lawyer for the hospital.

The cost to the employee associated with this problem was calculated at $358.84, including $225 in attorney fees, $59.84 in lost wages, $28 in transportation to court and $46 in court fees. In addition, the employer lost the services of the employee for two mornings, the federal government lost approximately $11.80 in tax revenue on the employee's lost earnings and the hospital had to pay its attorney to handle the case in court.

The point of this story is that the attorney indicated afterward that had she been called as soon as the employee started receiving past-due notices from the hospital, she could have negotiated a payment schedule with the hospital by phone, avoiding the law suit, court appearances, costs, time off from work and the worry which had plagued the employee during the three months while this situation was developing.

With a legal services plan this problem probably would have been resolved very early and quickly, to the benefit of all concerned. Since the cost of legal help would not have been a barrier, the employee probably would have consulted a lawyer at the "past due" stage, since he didn't feel he owed the money. Even supposing he waited until a suit was filed before seeing a lawyer, a quick settlement would have prevented any need for court appearances and lost wages.

Section 120 contains strict anti-discrimination rules. Legal services plans are a middle-income benefit; they have never served as a "perk" for top executives or a tax shelter for business owners. Plans benefit the 70% of Americans that studies show are likely to have unmet legal needs.

Congress was wise in 1976 to make section 120 temporary in order to force an evaluation of its effectiveness. Now it is time to make the section permanent, because today we know that the promise of legal services plans is being fulfilled. Ten years of experience have demonstrated that plans deliver needed services efficiently and inexpensively. The number of people covered by a qualified group legal services plan has risen from 100,000 in 1976 to over 5 million today. The cost to employers has remained level, at $50 to $120 per family per year, despite high inflation rates during much of the period. Direct tax revenue loss has been minimal. Preventive legal services through plans have saved tax dollars by reducing the use of our courts. And the economy has benefitted from increased productivity when employees' personal legal problems were quickly and efficiently resolved.

Further delay in making section 120 permanent will only delay the spread of these worthwhile plans to the more than 150 million Americans who stand to benefit from a legal services plan. We therefore urge that the President's recommendation to make section 120 permanent be adopted.

Statement of the
Machinery and Allied Products Institute
to the
Committee on Finance
United States Senate
Concerning the
Reagan Administration's "Tax Reform" Proposals
Pertaining to Employee Benefits
August 7, 1985

Introduction

The Machinery and Allied Products Institute (MAPI) is pleased to have this opportunity to comment to the Senate Committee on Finance concerning the Reagan Administration's "tax reform" proposals as they pertain to various employee benefits. This is our third presentation to the Committee regarding the President's proposals, earlier ones having dealt on July 12, 1985, with certain provisions adverse to capital formation and, on July 22, 1985, with certain initiatives that would harm the international competitiveness of U.S.-based businesses and their foreign affiliates.

MAPI and Its Interest

As the Committee may know, MAPI is the national organization of manufacturers of capital goods and allied products. The Institute and its affiliate, the Council for Technological Advancement, act as national spokesman for the industries they represent and conduct original research in economics and management. Apart from traditional capital goods product lines, MAPI's constituency includes leading companies in the electronics, precision instruments, telecommunications, computer, office systems, aerospace, and similar high technology industries. All of the Institute's member companies provide their people with "employee benefits" as an integral part of the employment arrangement. Consequently, we have a direct interest in any changes that would diminish the value of such programs and/or unduly complicate the administration of them.

In referring generically to "employee benefits," we have in mind such programs of a voluntary nature (i.e., excluding social security, workers' compensation, unemployment compensation, etc.) as pension plans, capital accumulation plans, disability protection, health insurance, group-term life insurance, and financial aid for educational purposes. To a greater or lesser extent, programs of this type involve tax deferral or tax exemption because of their socio-economic significance and the priority thus assigned to them by government. Benefits of other types (e.g., free parking, subsidized cafeterias, paid vacations, and paid sick leave) may be taxable or exempt depending on the item in question and/or the circumstances. Although some such benefits would be altered by the Administration's proposals, they are not the principal focus of this statement. Further, no inferences should be drawn concerning MAPI's position on any issues not discussed further herein.

Our Position, in Brief

To state our position in summary terms, we do not agree with all of the Administration's goals in this area of tax policy, and we are convinced that several of the initiatives would be counterproductive. In our view, certain of the proposals (1) represent a potential further reversal of public support for private retirement and savings plans; (2) would further complicate administration for employers and government, and complicate savings and retirement planning for many individuals; (3) would render employer-sponsored plans more costly to operate and less salutary to participants, with adverse effects on sponsorship, participation, coverage, and benefits; (4) would reduce plan and participant flexibility to meet savings and retirement needs; (5) constitute an inequitable change of the rules "in the middle of the game" for many participants; and, (6) last but not least, would have a numbing effect on one of the more prolific sources of savings in the economy, thereby dealing another blow to capital formation that already would be stunted by other "features" of the Administration's recent tax initiatives.

More specifically, we oppose all or portions of the proposals intended to do the following:

--Make uniform the rules for distributions from tax-favored retirement plans, including repeal of capital gains and ten-year averaging for lump-sum distributions, taxation of unrealized gain on securities distributed in stock-bonus plans, and elimination of the special basis recovery rules for qualified plan distributions. These provisions exist in the interest of plan participant fairness and flexibility, and should not be changed.

--Amend the deduction rules for tax-favored retirement plans, including new compensation limits and a new tax on excess contributions. The new compensation limits would have unanticipated consequences for plans with length-of-service factors in their contribution formulas and need more study.

--Modify the annual limits on contributions and benefits with respect to tax-favored plans. Certain of these provisions would discourage after-tax contributions by employees, contrary to desirable policy objectives.

--Apply a "recapture" tax of 10 percent on plan funds reverting to an employer upon plan termination. This could act as a penalty to terminations with asset reversions, and should not be enacted without addressing the issue directly and in conjunction with other committees having jursidiction.

--Revise cash or deferred arrangements (CODAs), including new annual limits, restrictive distribution and matching provisions, and tighter non-discrimination rules. These provisions would vastly complicate CODA administration, and indirectly put new curbs on participation. We urge that the existing rules be continued.

--Apply an objective nondiscriminatory coverage test to all qualified plans, and permit a 125 percent disparity between prohibited group coverage and coverage of other employees. This would require changes to untold numbers of plans now in compliance with existing law, and neither the administrative burden nor the additional limitations on coverage can be justified.

--Include in an employee's gross income employer contributions to a health plan up to $120 per year for individual coverage of an employer or $300 per year for family coverage. We oppose taxation of these benefits.

Before turning to our specific concerns, we have remarks of a general nature to offer about "tax reform" and other regulation of employee benefits.

In General

Priorities

A threshold consideration in evaluating the Administration's proposals as they pertain to employee benefits is the priority to be assigned to retirement savings and to savings generally. For nearly as long as there has been an income tax, private savings--notably, but not exclusively, for retirement--have been encouraged in the interest of higher levels of investment, increased productivity, and a significant private-sector role in assuming responsibilities that otherwise might fall to government. To our knowledge, nothing has changed, and most independent observers still conclude there should be even greater incentives to private savings generally in the United States. Meanwhile, Social Security, i.e., the retirement portion of the "social safety net," increasingly is mentioned as the ultimate target for federal budgetary deficit reduction. Acknowledging that resources are scarce but still mindful of the importance of U.S. savings overall and retirement policy in particular, we question the wisdom of further substantial restraints on private-sector involvement.

Regulatory Burden

In addition, private plans for savings and retirement have been saddled with a heavy regulatory burden in recent years--completely apart from the increment now proposed by the Administration. We refer to the Employee Retirement Income Security Act of 1974; the Multiemployer Pension Plan Amendments of 1980; the Tax Equity and Fiscal Responsibility Act of 1982; the Retirement Equity Act of 1984; the Deficit Reduction Act of 1984; and regulatory implementation of all the foregoing by the Department of Labor, the Internal Revenue Service (IRS), and the Pension Benefit Guaranty Corporation (PBGC). For the most part, these changes in qualified plan rules have presented employers with additional costs of funding and administration. Meanwhile, on yet another "regulatory" track, the private-sector Financial Accounting Standards Board has come ever closer to prescribing accounting changes that would add certain questionable pension liabilities to employers' balance sheets. Under the circumstances, the new proposals seem rather like "overkill."

Fine Tuning?

In offering these comments, we do not quarrel with measures that would deal appropriately with tax-avoidance miscreants, self-dealers, persons who discriminate, or employers that bind themselves and later renege. On the other hand, the applicable law already is a quagmire of "do's" and "don't's" with respect to coverage, vesting, integration, distributions, limits on contributions and benefits, asset reversions, and more. In the quest to "fine tune" private savings and retirement plans until they are flawless by someone's standards, we hope the Committee will recognize that these plans are--and should remain--voluntary, and are intended to supplement rather than replace or duplicate the basic protections afforded by public programs. Also, we think it noteworthy that--by government count--48.5 percent of the nonagricultural workforce in the United States (amounting to 44.3 million workers) was covered by employer pension plans in 1983./1 These plans have been highly successful, and Congress should fully consider the vital role of private-sector arrangements before imposing further requirements that could trigger curtailments or establish hurdles to plan formation and growth.

An Unstated Motive?

The Administration's proposals as they would affect employee benefits have any number of stated objectives, but also one that largely goes unspoken, namely, to raise revenue--now or later--to help finance runaway federal spending and swollen budgetary deficits. Wherever a tax would be increased or accelerated in the Administration's plan (reportedly intended to be tax-neutral overall), a rationale is provided alleging inequity or complexity of the status quo. In our opinion, the Committee should not accept these statements at face value because a number contradict established policy favorable to employee benefit plans, and certain others employ either disingenuous egalitarian or

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1/ Of those not covered, most are ineligible by reason of inadequate number of hours worked, self-employed, etc.

"free market" rhetoric in support of proposals that are nothing more than revenue enhancers.

For example, the proposals to force most tax-favored amounts into a retirement-annuity mode and to eliminate hardship distributions could be very damaging to plan participation. Elimination of part of the health plan exclusion would be "the camel's nose under the tent," leading to still more taxes and lessened participation. Taxing the unrealized gains on securities in stock bonus plans would be a gross deviation from equitable tax policy, evidently an extension of similar moves already partly undertaken with completed-contract accounting and now proposed for "inside buildup" in some life insurance policies. Little or no attention is given in the Administration's proposals to views such as these that are widely held by employee benefits experts and corporate tax administrators. Nor is space devoted to such larger policy questions as might involve, for example, the impetus that would be given to nationalized health care if employer-paid health insurance premiums were to be taxed.

Changing the Rules

There are some glaring inequities in the Administration's proposals. First and foremost with respect to employee benefits, the proposals deal with plans in which many persons have participated for most or much of their careers. These individuals have saved diligently in order to care for themselves in comfort and dignity during their leisure years. Moreover, they have planned their affairs in accordance with legal requirements and plan provisions that gave them certain rights and privileges as to their deferred compensation. Obviously, these persons cannot relive their careers and redesign their futures to take into account the day-to-day vagaries of Administration thinking about "tax reform." Consequently, in the spirit of fundamental fairness, the Committee should provide affected parties with liberal transitions if any adverse proposals were enacted.

These transitions should include options by which individuals, such as those mentioned earlier, could be completely "grandfathered" as to amounts lawfully deferred, excluded, or otherwise tax-favored through the effective date of any adverse changes. The effective dates, in turn, should be delayed until some date sufficiently beyond enactment to allow employers to amend their plans and communicate the information fully to employees. This recommendation is especially important in the context of new restrictions on distributions. As already indicated, Congress has enacted new laws affecting employee benefits with some frequency lately, and the more recent enactments have not even been implemented by regulations that will govern plan amendments. A little congressional restraint here would be both admired and appreciated.

Pettiness

Certain proposals deserve passing mention--not to be dealt with further herein--because they seem either petty or insensitive. In the former category, we refer to such items as the planned repeal of the exclusion for employee awards and curtailment of the business meals deduction. In the latter group, there are such conspicuous items as proposed repeal of the exclusion for up to $5,000 in employer-provided death benefits. In our opinion, the IRS quandary as to whether employee awards and/or death benefits are gifts or taxable income is a "tempest in a teapot," and the proposal would have government intrude into matters so minor in individual cases as to warrant a contrary policy decision in favor of the affected practices. Curtailment of the business meals deduction evokes mixed feelings because there reportedly is some abuse, but, on the other hand, business meals--however sumptuous--can be as legitimate for deduction purposes as any other direct or indirect costs of doing business. Scattered acts of noncompliance do not make a case for repeal.

The Committee should examine the Administration's proposals at least partly with a view to scrapping those that are arbitrary, trifling, and/or so callous as to promote resentment of the system and taxpayer noncompliance.

Revenue Estimates

The Administration estimates that its "retirement savings" proposals would generate tax revenues from individuals in the amount of $1.9 billion in fiscal year (FY) 1986 (beginning October 1, 1985), rising to $5.8 billion in FY 1990, the latest year for which an estimate is available. The proposal to tax employer-provided health insurance is estimated to raise $2.4 billion from individuals in FY 1986, rising to $4.0 billion in FY 1990. We cannot speak to the accuracy of these estimates because they were made by Treasury, and neither the underlying data nor the assumptions have been revealed. If the estimates were made on a relatively static basis, without attention to "ripple effects" and the likely behavioral adjustments of affected parties, then the revenue gains may be understated. We believe this to be the case because the pace of plan participation would be reduced as some individuals' preferences shift toward compensation and away from benefits that are infrequently used (e.g., health insurance for young workers) or deferred compensation that would not be accessible in times of hardship (e.g., savings in Section 401(k) plans). The Committee should ask Treasury to explain the basis for its revenue estimates.

Having stated that the revenue gains may be higher than estimated, we hasten to add that they still are not very significant in relation to actual tax collections overall, to the so-called "tax expenditure" budget, or to the Administration's "tax reform" plan overall. If needed and justified, equivalent revenues could readily be raised elsewhere without disturbing retirement-savings plans and other tax-favored benefits. Indeed, in the case of retirement-savings plans, tax revenues are simply deferred and generally will be paid later, although at reduced rates. They are not, however, excluded or forgiven.

Specific Comments

Distributions

In pertinent part, the Administration proposal would subject all tax-favored plans, including tax-sheltered annuities, to uniform minimum distribution rules. Both lifetime and after-death distributions would have to conform with minimum payout schedules. Failure to satisfy these rules would result in a nondeductible excise tax equal to 50 percent of the amount by which the minimum amount required to be distributed exceeds the amount actually distributed. The current sanction of plan disqualification would be eliminated.

Tax-sheltered annuities, including annuity contracts and retirement income accounts, would be subject to the distribution restrictions currently applicable only to custodial accounts, and financial hardship would be eliminated as an event permitting distribution.

Distributions would be subject to tax only upon actual receipt, and the doctrine of constructive receipt no longer would be applied. Also, the taxable portion of a distribution from a tax-favored plan would be taxed fully as ordinary income. The special capital gain and ten-year averaging treatment for lump-sum distributions and the deferred inclusion of unrealized appreciation on distribution of employer securities would be eliminated. The basis recovery rules would be reversed so that an amount received before an annuity starting date would be treated, first, as a taxable distribution and, second, as a nontaxable return of basis.

A recapture tax would apply to "early distributions" (as defined) from tax-favored plans, with the taxable portion being subject to an excise tax of 20 percent. However, if the early distribution were to be used to pay for college expenses incurred by a dependent, or for the purchase of the individual's first principal residence, or to replace unemployment benefits during a period of unemployment following the cessation of such benefits, the rate of the recapture tax would be reduced to 10 percent. The tax would be nondeductible and could not be offset by deductions or credits otherwise available.

Individuals generally would be permitted to make tax-free rollovers of funds, within 60 days, between tax-favored plans, subject to certain limitations on rollovers and transfers to prevent avoidance of the minimum distribution rules.

The proposed rules governing distributions generally would apply to distributions from tax-favored plans on or after January 1, 1986, in years beginning on or after that date, with special transitions provided in some instances.

Comment.--We are concerned by the distribution proposals because they would severely alter the existing rules and create new impediments to plan participation.

Specifically, persons of limited means would be much less likely to participate in savings plans in which their funds would be locked up until retirement or be available only at great cost prior to retirement to contend with emergencies or sudden financial needs of high priority. Also, it would be highly inequitable to reverse the existing basis recovery procedure, to tax unrealized appreciation upon distribution of securities, and to eliminate the lump-sum-payment relief provisions. Apart from pre-retirement withdrawals, there are retirees that may want to take down part of their savings in some form other than an annuity in order to finance a retirement home or meet some other need. When people have saved in accordance with the prevailing rules that have encouraged deferment of compensation and consumption, they should be entitled to use their savings however they see fit.

If there is a disparity between the harsh withdrawal provisions of Individual Retirement Accounts (IRAs) and those of other savings plans, then the direction of uniform change might better be toward the latter and away from the IRA-type rules currently in place. It is noteworthy to us that the same Administration that has advocated more savings and investment generally, including "special [tax-favored] savings accounts" for future higher education expenses of dependent children, tuition tax credits, etc., now finds difficulty with savings plans that never were dedicated exclusively to the establishment of retirement annuities. Let us add that anticipated retirement needs are important motivations to saving whether government requires such an application or not in exchange for tax relief. Regarding the capital gain and 10-year averaging items, the original purpose was--and still is--to mitigate the effect of the progressive tax structure on individuals receiving all their benefits in a single year. The same purpose is not now served by permitting individuals to roll over distributions into an IRA if the lump sum is unavailable without penalty.

Although we do not have data to present concerning "premature" plan withdrawals, we rather doubt that they are rampant. Further, our exposure to plan administrators indicates that many with tax-favored savings arrangements for employees discourage their use as "short-term savings accounts"--to use the Treasury terminology--although they may be available for nonretirement purposes under certain circumstances. In our opinion, the proposals would present formidable barriers to retirement savings for many individuals in an effort to defeat nonretirement uses of tax-favored amounts by a few.

In the case of employer securities, taxation would occur at the time of distribution in place of the deferral now available. In our opinion, it is fundamentally unsound to tax unrealized appreciation because no funds are available from the object of taxation (i.e., the securities) to use for payment--in the absence of liquidation. Treasury contends that securities with deferred gain often are rolled over into IRAs, and that the opportunity to defer tax after distribution and to escape tax altogether if the securities are unsold after death permits the use of tax-favored plans for a non-retirement purpose. We question the extent to which this occurs and whether departure from the realization principle for all stock bonus-type plans is an equitable response.

Deductions

Among other proposals, the Administration would eliminate the 15-percent-of-aggregate-compensation limit on deductions for contributions to profit-sharing and stock bonus plans. The current annual limit on the deductibility of the contributions for any individual in a defined contribution plan would be modified so that the contributions to a profit-sharing or stock bonus plan for any individual could not exceed 15 percent of that individual's compensation for the year. Excess contributions would be deductible in a succeeding year subject to the 15 percent of compensation limit for that year.

Although excess contributions could be carried forward, a carryforward of an unused limit to a succeeding year would generally be prohibited, subject to certain exceptions for employer contributions with respect to a "retirement-type," profit-sharing plan (as defined).

The 25-percent-aggregate-of-compensation limit would be modified by applying the limit to combinations of defined contribution plans and defined benefit plans.

An excess contribution to a tax-favored plan would generally not trigger plan disqualification. However, it would be subject to an annual tax of 10 percent for the year of contribution and for as long as the excess contribution both remained in the plan and was nondeductible.

The proposals generally would be effective for years beginning on or after January 1, 1986, with transitions to accommodate certain special situations.

Comment.--Although we acknowledge Treasury's concern that some employers have been able to contribute more than 15 percent of compensation for highly paid individuals and less than 15 percent for lower-paid individuals participating in profit-sharing and stock-bonus plans, replacement of the aggregate limit with one that is applicable to each individual would seem to have some potential for complicating plan administration. Perhaps more importantly, the proposal could restrict plan design in ways that may not be desirable. Most frequently mentioned is the situation of plans containing length-of-service factors in their contribution formulas, especially as they would affect those rank-and-file employees of long service who are nearing retirement. We suggest that the Committee look into these alleged side-effects of the proposal and have Treasury prepare special exceptions or find some less disruptive way to accomplish its purpose.

Contributions and Benefits

The Administration's proposal would--among other changes--do away with the overall limit on the annual contributions and benefits that may be provided to an individual under a defined contribution and a defined benefit plan--other than for top-heavy plans.

An additional 10 percent recapture tax would be applied to taxable, tax-favored benefits distributed to or with respect to a participant from all plans, including IRAs and tax-sheltered annuities. The tax would be applied to the amount by which such annual benefits exceed 1.25 times the defined benefit dollar limit in effect for the year, and the tax would be nondeductible and nonoffsetable. However, the 10 percent recapture tax on excess annual distributions would be coordinated with the 20 percent recapture tax on early distributions to prevent duplication.

In determining whether the separate plan limit for an employee in a defined contribution plan is satisfied, one-half of all employee contributions would be treated as annual additions on behalf of the employee. Also, the special limits for employees of certain tax-exempt organizations participating in tax-sheltered annuities and for employees participating in ESOPs would be eliminated.

The modifications to the annual limits on contributions and benefits would apply to plan limitation years beginning on or after January 1, 1986, or--where applicable--to limitation years beginning after termination of a collective bargaining contract. The 10 percent recapture tax would apply to tax-favored distributions made on or after January 1, 1986, in taxable years of individual recipients beginning or after that date.

Comment.--We object in principle to one portion of this proposal which would increase the circumstances under which employee contributions to tax-favored plans count against the limitations on benefits. Treasury complains that these contributions accumulate income on a tax-deferred basis and that highly-paid individuals generally are in a better position to take "disproportionate" advantage of the tax benefits enjoyed by their contribution. However, Treasury does not mention that the employee contributions involve after-tax amounts and that the individuals choosing to contribute--if highly compensated--generally have paid "disproportionate" taxes on the income from which the contributions are made. Nor does Treasury mention the priority that should be placed on encouraging individuals to have an after-tax stake in these arrangements. In our opinion, this further proposed restriction on computation of the limitation should be refused by the Committee.

On a related matter, we note Treasury's concern about multiple-employer cases wherein tax-favored treatment may be accorded to "unreasonable" accumulations, benefits, etc. Without specifically objecting to the remedy, we should at least observe that it would be arbitrary and result in taxes being imposed on "excess" deferred compensation under some circumstances in which no shareholder, director, or other interested party would agree with the characterization. In other words, exceptions to the proposal should perhaps be considered.

Asset Reversions

The Administration would apply a 10 percent excise tax to plan funds reverting to an employer upon plan termination, the alleged purpose being to recapture some portion of the tax advantages provided with respect to those funds prior to termination. The tax would be nondeductible and nonoffsetable, and would be applicable to qualified plan assets reverting to an employer pursuant to plan terminations occurring on or after January 1, 1986.

Comment.--We are unaware of any employers who deliberately overfund pension plans with a view to future asset reversions and the accompanying "tax benefits" from the experience. Indeed, given the degree of regulation and actuarial and accounting oversight, one might conclude that the option of plan termination only arises as a result of actuarial error, and is more a fortuitous occurrence than anything planned by the employer. Under specified circumstances, the tax Code and ERISA allow an employer to terminate a defined benefit pension plan, satisfy the liabilities to employees and their beneficiaries, and take the remaining assets. Such terminations as occur are accomplished by following "Implementation Guidelines" developed jointly by Treasury, the Department of Labor, and the Pension Benefit Guaranty Corporation (PBGC), as issued on May 24, 1984. The amount of a reversion is includable in gross income of the employer.

In our opinion, the Committee should not apply a 10 percent excise tax to asset reversions while this entire area of policy is under investigation by other congressional committees and cognizant agencies such as Labor and PBGC. Although the excise tax proposal poses as a "nominal" recapture of tax benefits, the benefits would have been received by the plan at a time when there was no foreknowledge that a reversion would occur and in connection with plan contributions and asset accretions that simply earned the tax protection provided by law. Inasmuch as the tax benefits for retirement plans are provided to remove the disincentive otherwise interfering with adoption of a plan and inasmuch as any liabilities must be satisfied upon plan termination, we fail to see the need for imposing an excise tax. Also, as noted, the asset reversion is includable in gross income of the employer.

We note in passing that this proposed "recapture" of tax in connection with asset reversions would not be unlike the infamous Administration proposal to impose a "recapture" tax on certain depreciation allowances taken since 1980.

Regarding Treasury's alleged concern about asset reversion from continuing plans, we understand that the Internal Revenue Service (IRS) previously has allowed transfers of excess assets directly from defined benefit plans, without termination, to an employer's qualified defined contribution plan, without either income inclusion or deduction by the employer. More recently, IRS has indicated that its position is being reexamined. Presumably, this will be the subject of an administrative proceeding. However, we see no direct connection between this professed concern and the proposal at hand, unless the real purpose of the excise tax would be to serve as a penalty to asset reversion. Again, we believe that Committees with labor jurisdiction, among others, should be involved in such decisions.

CODAs

The Administration would modify the rules governing cash or deferred arrangements (CODAs) under Section 401(k) so that an employee's elective contributions for a year would be limited to $8,000. Elective contributions would continue to count as employer contributions against the annual contribution and benefit limits for tax-favored plans.

Deductible IRA contributions by an individual for a year would count against the dollar limit on elective contributions under a CODA by such individual for the plan year beginning in the calendar year to which the IRA contributions relate.

The "actual deferral percentage" (ADP) test for elective contributions to CODAs would be modified several ways. First, the "prohibited group members" in applying the ADP test for a year would be those employees who, at any time during the three-year period ending on the last day of the year in question, meet any one of the following descriptions: (1) owners of 1 percent or more of the enterprise (under appropriate attribution rules); (2) employees receiving at least $50,000 in annual compensation; (3) employees who were among the top 10 percent of employees by compensation or who were among the highest three employees by compensation, but not if they received less than $20,000 in annual compensation; or (4) family members of a prohibited group member with respect to such year. Certain of these criteria would be flexible, and the dollar amounts indicated in the criteria would be indexed for inflation.

Two other changes to the ADP test would involve an alternative "deferral ratio" approach and a 10 percent tax on contributions in excess of the applicable deduction limits where the deferral ratio for any prohibited group member for a year exceeded the applicable limit for that year.

Under a nondiscriminatory eligibility test, the ratio of prohibited group members eligible to make elective contributions under the CODA to the total prohibited group members could not exceed 125 percent of the analogous ratio for the other employees. Certain employees could be disregarded.

Further, a CODA would be precluded from requiring, as a condition of eligibility, employees to complete more than one year of service; the CODA distribution restrictions would be modified to preclude distributions of amounts attributable to elective contributions before the employee's death, disability, or separation from service, or plan termination; an employer would be prohibited from conditioning, either directly or indirectly, contributions and benefits (other than employer matching contributions) to employees' elective contributions under a CODA; and CODAs would be available only to taxable employers.

Regarding employer matching contributions, special nondiscrimination rules would be applied to encourage employer matching on a fully nonforfeitable basis and subject to the CODA distribution restrictions; to assure that employer matching contributions are actually being provided to broad cross-sections of employees on a nondiscriminatory basis; and to prevent the design of plans using employer matching to deliver disproportionate tax-favored benefits to highly paid employees.

The proposals relating to CODAs and employer matching contributions would apply to plan years beginning on or after January 1, 1986. For collectively bargained plans, the proposals would apply to plan years beginning after the termination of the collectively bargaining agreement. However, an employee's accrued benefit under a CODA as of the last day of the first plan ending on or after December 31, 1985, would continue to be subject to the current law distribution limits on elective contributions.

Comment.--We believe that these proposals would limit the usefulness of CODAs, notwithstanding they have been the fastest growing tax-favored form of savings-retirement plan. First and foremost, employees could no longer withdraw their funds without penalty in case of a financial hardship or upon reaching age 59-1/2, and this would be a serious impediment to participation by persons of limited means. Additionally, there would be new and more rigorous requirements for company matching contributions, which are very important incentives to participation by rank-and-file employees. Before any steps of this nature are taken, the Committee should assess—as already mentioned—the vital role and priority of these plans and decide whether contraction of public suppport for private retirement-savings programs should be undertaken simultaneously with reductions in the applicable public programs.

In our opinion, it is untimely to present impediments of this kind to CODA participation, even if changes are made to preclude matching practices that could be "discriminatory." In that connection, we do not endorse the proposed "antidiscrimination" steps because—as discussed subsequently--they will entail costs of administration that plan sponsors may find objectionable, and are not necessarily the appropriate remedies for broadening access to these programs. Further, the Committee must be wary of the distribution and matching proposals because they would dampen the propensities of lower-income employees to participate and CODAs would not otherwise continue to grow and achieve their tax-favored purposes under these circumstances. If CODAs are being used somewhere as tax-exempt savings accounts, an obvious alternative to the proposed distribution rules would be to correct the misinterpretation of "hardship." The Committee may wish to ask Treasury why it still has not acted to finalize CODA regulations under the Revenue Act of 1978.

On several administrative points, we are amazed by the complication that would be introduced into CODAs in the name of "simplification." Even with expertise, one scarcely can decipher how all of the Administration's employee benefit proposals hang together. For example, CODA contributions apparently would have to conform to Section 415 limitations as well as the "actual deferral percentage" test, the matching contribution provisions, the IRA offset, other offsets, and the new $8,000 limitation. Evidently, too, much of the compliance testing would be accomplished individual-by-individual. One wonders nearly in exasperation how CODA amounts could be coordinated with individuals' IRA contributions on a person-by-person basis and with April 15 deadlines past year-end for the latter. What sort of recordkeeping would be entailed where "prohibited groups" would include a "family member" of another prohibited group member and certain employees who may have separated from the enterprise up to four years ago? Is it "simplification" to impose these wholesale changes on thousands of plans that still await implementation of the 1978 legal requirements?

These questions tend to answer themselves, in our view. We are opposed to the withdrawal provisions, and believe that the current CODA percentage deferral test should be left intact. If something must be done along the lines of "antidiscrimination," the annual cap on employee deferrals will suffice. However, $8,000 is too low an amount, and we do not agree with the IRA offset. Further as to the latter, if there is to be an offset, we recommend that individuals rather than plans be responsible for compliance.

Nondiscrimination Coverage Test

A profit-sharing, stock bonus, pension, or annuity plan would be required to satisfy a nondiscriminatory coverage test as a condition of tax qualification. Under this test, the percentage of the employer's prohibited group members benefiting under the plan would not be permitted to exceed 125 percent of the percentage of the employer's other employees benefiting under the plan. Employees in a class of excludable employees would be disregarded in applying this 125 percent test if the plan does not benefit any employee in that class.

A "prohibited group member" would be defined in the law, and some flexibility would be built into the criteria to take into account such matters as salary structure, change in size of the employer's work force, and inflation's effects on fixed dollar amounts. Also, the law would describe four classes of employees that would be treated as excludable in applying the 125 percent coverage test.

In very limited situations where compelling business reasons indicate that application of the 125 percent test would not be appropriate, an employer would be permitted to obtain a timely ruling from IRS that the employer's plan satisfies the nondiscriminatory coverage test even though it fails to satisfy the 125 percent rule.

Among other provisions, the proposal would require that any classification of employees used by a plan for participation purposes be nondiscriminatory on its face. Also, for purposes of the nondiscrimination test, plans covering a common prohibited group member would be treated as a single plan.

The proposed nondiscriminatory coverage test would apply to plan years beginning on or after January 1, 1987. For collectively bargained plans, the test would not apply to plan years beginning before the termination of the collective bargaining agreement.

Comment.--The nondiscrimination proposals would be complex in practice because they would apply to each benefit option and be measurable by participation rather than availability. As to the former, many employers--to take one example--offer different types and levels of coverage under their health insurance plans. This enables employees to choose coverages that meet their needs, rather than buy--or have purchased for them, as part of their compensation packages--medical insurance that they do not want. Under the proposal, it would appear that a standard "Blue Cross"-type arrangement might be found to be discriminatory if higher-paid employees select that coverage and lower-paid employees choose a health maintenance organization or similar option at lower cost. In testing for discrimination on the basis of participation rather than availability, Treasury evidently hopes to force employers into single-choice "lowest common denominator" plans, either to assure equality of treatment, to reduce Treasury's revenue cost, or both.

Another complicating element in the proposal would gear the discrimination test to all the employees of a controlled group of corporations. This makes little sense to us because compensation packages often differ by industry, location, and other factors, and it is not unusual that some corporate subsidiaries will have benefits that are not used elsewhere in the same affiliated group or that are used differently or more or less extensively. If entire controlled groups are to be tested, this flexibility will be lost for reasons that have nothing to do with discrimination. Again, the effect would be to limit choice, and this could mean reduced benefits for some persons in exchange for uniform coverage.

Finally, the nondiscrimination proposals would apply to virtually every tax-favored employee benefit. Presumably, most existing plans affected by the new requirements would require amendment, requalification, etc., to come into conformity. In striving to have more employee benefits be taxed as compensation, Treasury seems to care little about the administrative costs to employers of constant tinkering with plans.

In our opinion, the proposals in question should be scrapped. Treasury has not made a credible presentation to support changes that would be so sweeping, disruptive, and costly.

Health Insurance

Employer contribution to a health plan would be included in the employee's gross income up to $10 per month ($120 per year) for individual coverage of an employee, or $25 per month ($300 per year) for family coverage (i.e., coverage that includes the spouse or a dependent of the employee).

With respect to any employee, an employer's contribution to a health plan would be the annual cost of coverage of the employee under the plan reduced by the amount of the employee's contributions for such coverage. The annual cost of coverage with respect to an employee would be calculated by determining the aggregate annual cost of providing coverage for all employees with the same type of coverage (individual or family) as that of the employee, and dividing such amount by the number of such employees.

The cost of coverage would be determined separately for each separate plan of the employer. Coverage of a group of employees would be considered a separate plan if such coverage differs in a significant manner from the coverage of another group of employees. Also, nondiscrimination rules would be applied to employer-provided health benefits, regardless of whether employer health plans are self-insured or provided through third parties.

The proposal would apply to employer contributions received in taxable years beginning on or after January 1, 1986.

Comment.--Partial taxation to employees of employer contributions to a health plan is an idea whose time has not come. In our opinion, there were sound policy reasons for the exclusion when it was established, and the revenue needs associated with budgetary deficits from profligate government spending are not a good reason to add to employees' costs for these necessary services. The proposal is especially untimely in that health care cost containment programs already are raising employees' costs while curtailing services previously insured.

As numerous commentators have contended, younger employees tend to use health care services less than older insureds. Consequently, taxation of the premiums could cause younger workers to opt out of coverage in favor of other compensation or such other benefits as might be available. This would cause the overall experience of employee groups to worsen, with costs rising accordingly. Meanwhile, the administrative and related expenses of employers would increase due to new rules for determining contributions plan-by-plan, payroll administration, and--as noted earlier--antidiscrimination compliance. We should add that more than 60 million employees now are estimated to benefit from these plans, and, for the most part, neither they nor their employers see any merit in the proposal based on testimony received to date.

On points covered before in this statement, partial taxation of health insurance would lead to more and more future taxation of the same, and to taxation of other benefits. Also, this continuing pressure on health care benefits--however useful in "disciplining" providers and users--has implications for greater and more direct governmental intervention. Were it not for the current and projected deficits, the Committee would not be entertaining such proposals and we repeat that the taxation of health insurance is not the solution any more than the exclusion was the cause.

Concluding Comment

The Administration promotes its "tax reform" ideas under the banner of "fairness, growth, and simplicity," goals that are admirable in isolation from one another but notoriously incompatible in combination and scarcely achievable in the manner proposed. We urge the Committee to proceed with care because many of the proposals that have been offered are not acceptable to the vast majority of interested parties. Indeed, the spectrum of discontent is broad, and it continues to mushroom as more persons familiarize themselves with the unorthodox themes and their disruptive potential. Time is an important element in these deliberations because of the magnitude of the proposed undertaking and the attendant risk of policy error.

Regarding employee benefits specifically, the Committee should consider whether the existing set-up is so defective as to warrant costly changes to a great number of plans. Also, the Committee should ask what compelling need there is to alter the retirement-savings plans of millions of persons who have participated for many years and now look to such arrangements for their income security. Finally, the Committee should recognize that one purpose of Treasury evidently is to tax all "compensation" by stripping away the incentives from all employee benefits--a game plan that puts conceptual purity ahead of practicality, fairness, simplicity, growth, or any other desirable attribute. When the current exercise is completed, we believe Congress will find that the current system generally operates as intended; that there is no compelling need for change; and that Treasury's zeal to tax employee benefits of every kind is shared by a precious few.

* * *

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Metropolitan Life
AND AFFILIATED COMPANIES

John J. Creedon
President and Chief Executive Officer

October 4, 1985

The Honorable Bob Packwood
Chairman, Senate Finance Committee
219 Dirksen Senate Office Building
Washington, DC 20510

Dear Chairman Packwood

The Business Roundtable, an association of business executives of about 200 major corporations, examines public issues and develops positions that seek to reflect sound economic and social policy. I am writing to you today in my capacity as Chairman of the Business Roundtable Health, Welfare and Retirement Income Task Force. The Business Roundtable is continuing to develop its views on other aspects of the President's tax proposals. This letter and the attached statement deal with employer sponsored benefit programs.

The current tax proposals being considered by Congress would unfavorably impact employer sponsored benefit programs and the individuals covered under those programs. These aspects of the proposals could, therefore, lead to a curtailment of benefits provided under private sector programs and bring pressure upon the federal government to create or expand existing programs to provide benefits. Such a result, particularly in view of the current large deficit, is clearly undesirable.

As the attached statement spells out, we believe that legitimate public policy goals are served by providing tax and other incentives which encourage private sector employers to provide health, welfare and retirement benefits to individuals. Accordingly, we urge that those parts of the tax proposals which would reduce tax and other incentives for employee benefit programs be eliminated from the proposals. It is our belief that if consideration is to be given to changes which would affect the current employee benefit system either in connection with the President's current proposals or any other proposals, then such consideration should be based upon separate, careful and comprehensive study undertaken by the Administration, Congress and the public.

Sincerely

John J. Creedon

Attachment

October 4, 1985

THE BUSINESS ROUNDTABLE
HEALTH, WELFARE AND RETIREMENT INCOME TASK FORCE
STATEMENT ON THE TREATMENT OF EMPLOYEE BENEFITS UNDER THE FEDERAL TAX CODE

Background

Private sector pension plans, including 401(k) plans, promote important national social goals. They encourage increased and more widely distributed savings and result in the creation of funds which are critical for the nation's long term capital needs. They also produce retirement income to supplement Social Security and thus help the nation's elderly live out their retirement years in security and dignity. The public policy commitment to these goals is long standing, and is, in part, embodied in federal tax code provisions which provide favorable tax treatment of accumulated pension funds.

Private sector health and welfare plans, including cafeteria plans, are closely related to pension plans and also promote important social goals. They provide economic security in the form of comprehensive health, disability and life insurance protection. This protection is provided to a wide cross-section of the nation's active and retired workers and their families. The creation and continuation of these programs is encouraged by current and long standing national policy. As a result of the public policy commitment to these programs most of our country's workers, retirees and their families are well protected against the potentially catastrophic consequences of illness, disability and death.

Middle and lower paid workers receive the most benefit from voluntary employer sponsored pension, health and welfare benefit programs. The private sector programs which provide these benefits do so in a manner which is more efficient and cost-effective than public sector programs. Also, the private sector manages and finances these programs in a sound manner. This is in stark contrast to the ever present atmosphere of financial crisis which surrounds public sector programs.

Tax Proposals

During the past several years a number of tax proposals have been introduced which would unfavorably impact employer sponsored pension, health and welfare benefit programs and the individuals covered under those programs. For example, current proposals would cut back on 401(k) contribution limits; establish discrimination rules of questionable validity; radically change the taxation rules with respect to funds already accumulated under various pension plan arrangements by, for example, imposing sizeable new penalty taxes on many qualified plan distributions even with respect to amounts which have accumulated for many years with the expectation of the continuation of the current tax rules; and would impose a tax on employees covered under employer sponsored health benefit programs.

The Business Roundtable is concerned that the public policy commitment to health, welfare and retirement programs could be adversely affected by adoption of these or similar proposals.

Business Roundtable Position

The Business Roundtable believes that the federal government's encouragement, particularly from a tax perspective, of private sector pension, health and welfare benefit programs continues to be appropriate; it is our belief that to abandon existing incentives in this area in favor of tax simplification would be shortsighted in terms of sound social and economic policy. Thus, as the Business Roundtable continues to develop its views on the other aspects of the President's tax proposals, we urge that those parts of the proposals which would reduce tax and other incentives for employee benefit programs be eliminated from the proposals. It is our belief that if consideration is to be given to changes which would affect the current employee benefit system either in connection with the President's current proposals or any other proposals, then such consideration should be based upon separate, careful and comprehensive study undertaken by the Administration, Congress and the public. As an example, a comprehensive review of national retirement income policy was recently announced by Chairman Rostenkowski. Until that and other related studies are completed any legislation would be premature.

STATEMENT ON THE IMPACT OF THE PRESIDENT'S TAX PROPOSALS ON EMPLOYEE BENEFIT PLANS SUBMITTED TO THE SENATE FINANCE COMMITTEE

July 19, 1985

Submitted by:

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Statement on the Impact of the President's Tax Proposals on Employee Benefit Plans

I am Dwight K. Bartlett, III, president of Mutual of America Life Insurance Company. Mutual of America is a tax-exempt, non-profit corporation which is limited by its charter to underwriting employee benefit plans for non-profit health and welfare agencies. The organization is licensed in the District of Columbia and 48 states, with its home office in New York City and field offices in key cities throughout the country. At the end of 1984, Mutual of America was underwriting 32,000 employee benefit plans for approximately 13,000 non-profit health and welfare organizations. Its policyholders are many of the nation's prominent publicly supported charitable organizations, including the United Way of America, United Ways in numerous communities, Girl Scouts of America, Goodwill Industries, Council of Jewish Federations, American Cancer Society, Association of Junior Leagues, and other hospital, philantropic and charitable organizations.

Pension plans insured by Mutual of America include both defined benefit and defined contribution plans. Typically, the pension plans of Mutual of America's policyholders are small with twenty or fewer participants.

Mutual of America congratulates the committee for holding hearings on the impact that President Reagan's tax reform proposals will have on employee benefit plans and appreciates the opportunity to submit this written statement. Mutual of America applauds President Reagan and his tax advisors for addressing the need for a comprehensive tax reform plan. The President has made a commendable effort to infuse fairness, simplicity, efficiency, and compassion into our present tax system. Mutual of America strongly supports the thrust of the President's tax reform plan and supports, particularly, several provisions as they affect the operation of Mutual of America and the employee pension plans of its policyholders. Some provisions, however, affect unfairly the pension plans of non-profit organizations. It would appear that some of the tax reform proposals were drafted with for-profit organizations in mind, without consideration of their implications for non-profit organizations. In attempting to close loopholes or curb potential abuses in the pension plans of for-profit organizations, in some instances, the President has inadvertently created unfairness or unwieldy complexity for the pension plans of non-profit organizations. The purpose of this statement is to discuss the various provisions of the President's tax reform plan which Mutual of America specifically supports, and those proposals which Mutual of America hopes the committee will eliminate, amend, or clarify.

I. Proposals Supported by Mutual of America

Mutual of America supports many of the proposals set forth in the President's tax reform plan. A number of the proposals affecting retirement savings will undoubtedly be addressed by other organizations. We, however, want to discuss three of these provisions.

A. Uniform nondiscrimination rules should be established.

Mutual of America supports the application of uniform nondiscrimination rules to tax-qualified retirement plans. Under the current "facts and circumstances" test used to determine whether any particular plan is nondiscriminatory, employers are left with substantial uncertainty concerning whether their plans qualify. Through the elimination of this test and the imposition of a uniform set of rules, the President's plan creates an atmosphere of certainty, fairness, and simplicity. It may be that the President's proposal can be improved, but the basic values of uniformity and simplicity should be maintained.

B. Constructive receipt rules should be eliminated.

Mutual of America strongly supports the elimination of the constructive receipt rules as they apply to Section 403(b) benefit arrangements for employees of non-profit organizations. Under present law, benefits under most tax-favored plans are taxable only upon actual receipt; however, benefits under tax-sheltered annuities are treated as received either when actually distributed or when made available to the individual. As a result, the current law creates uncertainty (especially in light of the fact that the Internal Revenue Service is no longer issuing rulings pertaining to constructive receipt under Section 403(b) annuity plans) and significant disparities among individuals based on the type of plans to which the individuals happen to have access. By eliminating the constructive receipt rules for tax-sheltered annuities, and thereby taxing distributions from such plans only upon actual receipt, as is done for distributions from all other types of tax-favored plans, the President's proposal meets its stated goals of fairness and simplicity.

C. Section 415 aggregation rules should be eliminated.

Mutual of America supports the elimination of the overall limit on annual contributions and benefits that may be provided with respect to any employee under the defined contribution and defined benefit plans of his employer. The present law requires employers who provide both defined contribution and defined benefit plans to make arduous and unnecessarily complex calculations of the overall limit. Administrative complexity is a major disincentive to smaller employer's sponsorship of pension plans for their employees. Because the largest sector of noncovered workers is in small employers of 100 or fewer employees, the elimination of overall limits would do much to persuade these employers to sponsor plans.

Other provisions in the President's tax reform plan would adequately ensure that employees and employers would not abuse defined contribution or defined benefit plans. By retaining the separate plan limits for a defined contribution plan and for a defined benefit plan, and by imposing an excise tax on distributions in excess of specified dollar amounts, the President's proposal sufficiently limits the number of tax-favored dollars that may be distributed to highly paid employees. Overall limits would no longer be necessary. This simplification should make it easier for our policyholders and other employers to offer both defined benefit and defined contribution plans if it were in the interest of the employees to do so.

II. Proposals Not Supported by Mutual of America

Mutual of America specifically opposes five of the provisions in the President's tax reform plan. These provisions, contrary to presidential intent, add complexity and inequity and tend to affect unfairly non-profit organizations and their employees.

A. Excise tax on contributions in excess of the deductible limit should not apply to plans maintained by tax-exempt organizations.

Under present law, a for-profit corporation may accumulate, tax-free, excess contributions to tax-favored plans it maintains for its employees. In an attempt to offset this tax advantage given to for-profit corporations, the President's tax reform plan proposes to impose a ten percent excise tax on accumulated excess contributions. Although the language of the proposal covers all employers, the rationale behind that excise tax clearly does not apply to non-profit organizations. Non-profit organizations are tax-exempt and therefore have no incentive to overfund a tax-favored plan. An overfunded plan by a non-profit organization is the result of either actuarial miscalculation or administrative mistake; it is not an attempt to shelter excess contributions from taxes. Accordingly, the imposition of an excise tax on tax-exempt organizations is both unnecessary and unfair.

Moreover, such an excise tax would impose burdensome and complex calculations upon non-profit organizations. These organizations currently employ actuaries to determine the recommended annual contributions and the amounts necessary to meet minimum funding requirements of the Employee Retirement Income Security Act of 1974 ("ERISA"). Since the President's deductible limits are not necessarily coextensive with the ERISA minimum funding standards, tax-exempt organizations would be required to engage in a third set of calculations, in order to determine whether an excise tax on contributions in excess of the deductible limit was appropriate in any particular year. This burden would add to the costs of such organizations and divert resources from other needs. This unnecessary requirement of such calculations would be inconsistent with the President's stated goal of tax simplification.

B. Cash or deferred arrangements should be made available to tax-exempt organizations.

Under present law, cash or deferred arrangements ("CODAs"), authorized by Section 401(k) of the Internal Revenue Code, are available to both taxable and tax-exempt organizations. The President's tax reform plan proposes to preclude tax-exempt organizations from maintaining CODAs. This proposal, if enacted, would result in unfair treatment of both employees of non-profit organizations and these organizations.

Employees of non-profit organizations have traditionally been paid salaries lower than their counterparts in the commercial sector. Non-profit organizations are not able to offer their employees many of the incentives typically offered by for-profit corporations (e.g., stock option programs). In order to compensate more adequately their employees (and consequently be able to attract and keep qualified individuals), non-profit organizations need to have access to the range of tax-favored plans available to for-profit organizations for similarly situated employees. The President's proposal would deny the employees of non-profit organizations this highly desirable program, and would put the non-profit organizations themselves at a competitive disadvantage.

This disadvantage is real, not merely theoretical. Evidence shows that moderate income individuals have preferred participation in their employer-offered CODA plans over other types of employee benefit plans. For example, the American Council of Life Insurance reports that in a survey recently conducted among 250 corporate 401(k) plans, the average employee participation rate was 81 percent for CODAs, compared to a 17 percent participation rate for IRAs. Differential participation rates at incomes below $25,000 are particularly significant. The President's proposal therefore denies a selected segment of the workforce -- employees of non-profit organizations -- the option of participating in such a popular form of deferred compensation, the CODA. This incentive with the desirable social objective of ensuring adequate retirement benefits for all employees should be protected, without regard to the tax status of their employer.

The President's rationale for continuing the 401(k) program underlines the extent of this disparate treatment. His proposals would continue the provisions of Section 401(k), even though the Treasury's plan advocated their elimination. The President recognizes that CODAs are effective in encouraging employees to save for retirement. His proposals note the following attractive features of CODAs: (1) their flexibility, (2) the fact that many employers make employer matching contributions, and (3) the availability of plan loans and distributions in case of hardship or upon separation from service. (The hardship distribution would be eliminated under the proposals, and 401(k)s apparently would be excluded inequitably from the lower 10% distribution tax for education, home purchase or replacement of expired unemployment benefits.) Moreover, under 401(k) plans, the employee may use funds available for elective contributions in keeping with his own financial circumstances; he may elect to allocate his contribution to various employee benefit options that might be offered by the employer; he can catch up in a subsequent year for not having made elective contributions in an earlier year. These flexible features also make it easier for employers to contain employment costs while meeting the different needs of different employees.

These reasons for continuing the Section 401(k) provisions apply equally to the employees of both taxable and tax-exempt organizations. To deny the employees of tax-exempt organizations this attractive option is certainly not fair and equitable treatment. Section 403(b) and 457 plans cited in the President's proposals as an alternative to 401(k) plans for tax-exempt organizations are not an adequate substitute. Section 403(b) plans, for example, are not even available to non-Section 501(c)(3) organizations. Moreover, where 403(b) plans are used as the primary retirement plans, they cannot serve the supplemental purposes of 401(k). Section 457 plans are unfunded deferred compensation plans and thus do not have the security of 401(k) plans. In addition, Section 457 severely limits the amounts of compensation that can be deferred (the lesser of $7,500 or 33-1/3% of includable compensation). Thus, Section 403(b) and 457 plans are not viable alternatives to 401(k) plans.

In contrasting the treatment of the for-profit and not-for-profit sectors, perhaps most important, the for-profit sector can structure unfunded deferred compensation programs, without limit, and still offer 401(k) plans. It also should be noted that although the inclusion of employees of non-profit organizations in 401(k) plans would result in some revenue loss because of the anticipated increase in employee participation, there would be no revenue loss from non-profit tax-exempt employers due to their increased participation.

The President's proposals would eliminate the special 415 elections for 403(b) plan participants employed by education, hospital, religious organizations or home health agencies. These elections provide additional "catch-up" contribution exclusions in recognition of the need of long term moderately compensated employees of tax exempt organizations to make provisions, in the later years of their careers, for adequate retirement. Mutual of

America sees these provisions as quite valuable to many participants. It has contended in the past that it was unfair not to extend these special "catch-up" elections to 403(b) plan participants employed by health and human service organizations. The flexibility of 401(k) plans can offer some opportunity to "catch-up" to nonprofit employees. Thus, it would be doubly unfair to eliminate the 415 special election and the prospect of its equitable expansion, and at the same time deprive tax-exempt organizations and their employees of the opportunity to participate in 401(k) plans.

The only way to treat fairly the employees of non-profit organizations is to retain the current access to 401(k) plans for all employees. Employees of non-profit organizations should be allowed to participate in the same attractive CODA plans as do their counterparts in the commercial sector. To do otherwise would be inconsistent with the presidential goal of tax equity.

C. "Top-heavy" rules should be eliminated.

As stated earlier, Mutual of America supports the President's proposal to adopt simplified uniform nondiscrimination rules. The fairness and simplicity effected by uniform nondiscrimination rules will, however, be lost if Congress does not concurrently abolish the "top-heavy" rules for employers who maintain tax-favored plans. The "top-heavy" rules are administratively burdensome and unfairly discriminatory by imposing special conditions on some plans and not on others that are intended to modify the plans with respect to such issues as nondiscrimination and integration. The imposition of uniform nondiscrimination rules will effectively ensure that all tax-favored plans provide broad, nondiscriminatory coverage; the "top-heavy" rules would no longer be necessary to deal with that concern. To the extent that benefit allocation issues remain, they are the result of the complex and inadequate integration rules; the simplified nondiscrimination provisions should be accompanied by simple integration rules to assure a minimum benefit to low income workers under all plans.

D. The "inside build-up" on life and annuity contracts should not be taxed.

Under current law, owners of life insurance policies and deferred annuity contracts are not taxed on annual increases in the values of their life or annuity contracts which have not been realized. Under the President's plan, such owners would have to include as interest income any increase in the amount by which their contract's cash surrender value exceeds their investment in the contract. For numerous reasons, Mutual of America joins other members of the insurance industry to oppose such a revision of current "inside build-up" treatment.

First, taxing inside buildup would be contrary to the fundamental concepts of tax law. Since life insurance policyholders do not receive annual increases in their policy's cash surrender value directly or "constructively," they should not be forced to pay taxes on that amount. To do so would be the same as taxing as income the appreciation in the value of a home even though the owner has not sold it.

Second, life insurance is typically not a "loophole" for the rich. In 1983, 66% of permanent life insurance policies were purchased on the lives of individuals with incomes under $25,000 a year. Less than 5 percent of permanent life insurance policies are owned by individuals with family incomes in excess of $100,000. Accordingly, taxation of inside buildup would affect modest or middle income individuals the hardest.

Third, such taxation would make permanent life insurance more costly and less attractive. Reductions in sales of such policies would curtail life insurance company funds available for long-term investment and would impede capital formation so vital for the nation's economy.

Fourth, the President's proposal introduces new, complex and costly burdens on life insurance companies and their policyholders. By forcing them to identify and report amounts subject to this new tax, the President's plan substitutes complexity for simplicity.

Fifth, current law does not allow deferred annuities to escape tax; it only permits tax to be deferred. All income, therefore, is eventually taxed.

Sixth, a deferred annuity is a unique vehicle for assuring financial security in retirement because unlike any other form of retirement savings, it guarantees a level stream of retirement income for life. In general, the contract owner knows what his retirement income will be before reaching retirement and that his resources will not be exhausted prematurely.

Finally, adoption of this proposal would mean departure from the basic tax rule that says if there are substantial restrictions on an individual's ability to receive income, there will be no tax. An annuity owner cannot obtain the amounts which would be taxed without giving up valuable rights and guarantees.

E. Excise tax should not be levied on a lump sum distribution from a tax-favored plan.

The President's tax reform plan proposes to place a cap on distributions from all tax-favored plans equal to 125% of the defined benefit dollar limit in effect for a particular year. If these limits are exceeded, a 10 percent excise tax would be levied on the excess distribution.

If the excise tax were applicable to lump sum distributions, Mutual of America would strongly oppose this provision of the President's plan. An individual who decides to withdraw his retirement dollars in one lump sum distribution would be treated differently from the individual who elects to receive his distribution in the form of an annuity. The President's proposed elimination of the ordinary income averaging provision and the ten-year forward income averaging provision in the current law would create a sufficient tax penalty on lump sum distributions; the imposition of the 10 percent excise tax would compound that tax penalty most unfairly.

III. Provisions That Need Clarification

Mutual of America is concerned whether the President intends (1) to restrict distributions of an employee's voluntary nondeductible contributions to a qualified retirement plan prior to age 59-1/2 and (2) to impose the excise tax on distributions from contributions accumulated prior to the effective date of the President's tax reform plan. Such interpretations of the President's plan would be patently unfair to individuals who made such contributions based on law as it existed. To change the law "in midstream" would impact unfairly on these individuals who justifiably relied on the present Internal Revenue Code.

* * * * *

In conclusion, let me emphasize that Mutual of America supports President Reagan and this Congress in their admirable attempt to make the tax system in this nation more just and less complex. Many of the President's proposals do indeed meet the dual goals of justice and simplicity. Other provisions do not. Congress certainly should close loopholes that have lead to abuse; however, Congress must recognize that some loopholes that apply to the profit-making sector do not pertain to non-profit organizations. The task is to examine carefully each issue to ensure that legislation aimed at one group does not unfairly impact on the other.

I thank you for this opportunity to present this statement. I am available at any time to answer any questions that you may have about Mutual of America, its policyholders, or our opinions on the various proposals discussed above.

STATEMENT OF

LESLIE E. BAINS

PRESIDENT

NATIONAL ASSOCIATION OF BANK WOMEN

TESTIMONY SUPPORTING EMPLOYEE EDUCATIONAL ASSISTANCE EXTENSION OF INTERNAL REVENUE CODE SECTION 127

BEFORE THE

COMMITTEE ON FINANCE

UNITED STATES SENATE

August 2, 1985

My name is Leslie E. Bains. I am a Vice President of the Chase Manhattan Bank, N.A., New York, in charge of marketing, sales, estate and financial planning, and national expansion for Chase Manhattan's domestic private banking group which has $10 billion in assets. I am the President of the National Association of Bank Women, Inc. (NABW). NABW was founded by a small group of women bankers in 1921. In 1983, the focus of the Association was expanded to include women executives in all parts of the financial services industry. Today NABW has over 30,000 members in 375 local groups in all fifty states. Membership is open to officers or managers in commercial banking, mortgage banking, savings and loans institutions, corporate financial departments, and many other financial entities.

NABW's mission is to empower women in the financial services industry to attain professional, economic, and personal goals, and to influence the future shape of the industry. It offers its members a widely diverse selection of programs at all stages in their career development. Since 1973, NABW's Educational Foundation has provided extensive, sophisticated, and flexible programs on senior leadership skills, career planning, and management development. It is the leading source of such programs for financial women executives. Each year, these programs have attracted substantial numbers of NABW members and other industry employees at all levels. NABW publications, research surveys, and special reports provide a reliable resource for the financial industry on information reflecting the trends and future direction of the industry.

Consistent with its commitment to continuing education, NABW is pleased to have the opportunity to testify concerning the tax treatment of educational assistance provided by employers. Prior to the passage of the Tax Reform Act of 1978, educational assistance paid to or on behalf of an employee by his or her employer could be excluded from the employee's gross income for income tax purposes only if the education was directly related to the employee's current job. The employee training for a higher level position would be taxed on the cost of that educational assistance. In 1978, Congress enacted Section 127 of the Internal Revenue Code, broadening tax-free treatment of educational assistance to encourage employees, especially in lower level jobs, to use educational opportunities to expand their career opportunities. Section 127, which excludes employer-provided educational assistance up to $5000 per year from the gross income of the employee, is scheduled to expire on December 31, 1985. NABW supports its permanent extension and elimination of the $5000 limitation on the benefits.[1]

Preservation of the benefits provided in Section 127 would serve the nation's interest in encouraging its workforce to develop to meet changing times. The NABW supports the extension of Section 127 for the following reasons.

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[1] NABW supports the provision in the President's tax proposal to extend Section 127 permanently. NABW also supports enactment of S. 558 and H.R. 1356 which will be necessary to preserve Section 127 should tax reform fail to be enacted by December 31, 1985. NABW also endorses the position taken by the American Society for Training and Development regarding the non-discrimination rules. Enactment of the administration's current version of these rules would exclude important programs utilized by women in banking.

- -- Employees in the banking and financial industry find themselves in a highly fluid, changing environment. Education is essential to help them adjust to changes in the industry, new jobs, and promotional opportunities.
- -- Educational assistance for professional development has been a major factor in the advancement of women in the banking industry, contributing to their increase to 41 percent among banking officials and managers.
- -- A key part of NABW's program is to assist the career development of its members and all women in the financial services industry through its educational programs. NABW educational programs reach more than 14,000 industry employees per year. Taxing the fees paid for these programs would make it more difficult for employees to use these programs and for NABW to continue to offer them.
- -- Educational assistance is not a "perk" for top management. Taxing these benefits would particularly hamper lower-paid employees trying to upgrade their skills.
- -- Revenue losses will be offset by increased tax revenue from better qualified workers, lowered unemployment expenses, and greater workforce productivity.

Education Essential in Rapidly Changing Financial Services Industry

Section 127 has been important for the employees in many American businesses and industries. It has special relevance for employees in the banking industry today. The financial services industry is one of the fastest growing and rapidly changing segments of the American economy. Powerful forces--deregulation, the economy, technology, and new consumer demands--are changing the face of the industry. As Raoul D. Edwards, Editor of United

States Banker, has stated:

> After 50 years of isolation and insulation from the competitive marketplace, barriers are dropping all over, and the nation's banks and thrift institutions are faced with major challenges . . . What the banks and thrifts face is the need to adapt completely to a new world with new pressures and new competitors, new thrusts and new technologies, new management styles and management skills . . .

[Edwards, The Cultural Crisis in Banking, United States Banker, p. 10.]

Competition from other players in the financial arena, increased technology and an economy in which capital and investment strategy is increasingly complex are all forcing the industry to re-examine what constitutes a highly qualified bank executive. Employers and employees at financial institutions are meeting the challenges of this increasingly complex banking environment--complexities involving new technologies, changing markets, and rising international competitive pressure. The industry is changing so rapidly that banks and other financial institutions are greatly in need of knowledgeable, educated employees prepared to provide creative leadership and skills at all levels of finance and banking.

The banking industry recognizes the importance of a vital workforce in a rapidly changing industry.

> The business of banking is changing, and so are the people who work in the bank. . . .
>
> Today, bankers do a lot more than hold your money and make loans. . . .
>
> The nation's 14,900 commercial banks constitute one of the fastest growing industries in our economy, according to the Department of Labor, with an increase over

> the past decade of more highly technical workers with the rise in electronic and data-processing systems in banks.
>
> We are a labor intensive industry with a considerable commitment to training. . . .
>
> Bank officers, financial managers and clerical workers are among the fastest growing jobs for the coming decade, with the Department of Labor forecasting employment in these positions to increase at least 50% by 1990. . . .
>
> [T]raining and education, which have always been a cornerstone of the banking industry, proved to be high on the priorities of banks.

[Keith, Employment Gains in Banking by Women and Minorities, American Bankers Association Special Report, Bank Personnel News August, 1980, pp. 2-3.]

Advancement of Women in the Financial Services Industry

Women are not new to the banking industry. In the past, female bank employees tended to hold lower-level, mainly clerical jobs. Over the last decade, the picture has been changing. In 1972, a NABW survey showed that women represented no more than 10-12 percent of all bank officers. [Bryant, Women in Banking: Changes of the Decade, The NABW Journal, May/June 1981, p. 8.] United States Treasury Department figures indicate that in 1975 women constituted 25 percent of bank officials and managers. By 1978, according to statistics compiled by the Department of Labor and the American Bankers Association (ABA), this number was up to 30 percent. Today women constitute 41 percent of officers and managers in American banks. [Bryant, p. 8.] A 1984 survey conducted for the Wall Street Journal by the Gallup Organization showed that over 40 percent of women executives with the title of vice president or higher in companies with annual sales exceeding $100 million are in banks or other financial institutions. [Rogan, Top Women Executives Find Path to Power is Strewn with Hurdles, The Wall Street Journal, Oct. 25, 1984.]

Educational opportunities and programs have been and continue to be an important factor in this changing picture. In the early years, women's lack of formal education was a major hindrance to women in banking.

> Women entered the bank, on the whole, with less job-related education. Up until the early 1970s, the number of women enrolled in business school programs was miniscule . . .

[Bryant, p. 10.]

Those women who were already employed in banking had some experience and knowledge, but lacked management experience and formal education. Between 1978 and 1981, the number of women entering the Bank Marketing Association School of Management more than doubled, from 25 percent to 56 percent of the class. [Buckwalter, Women and Minorities in Banking, United States Banker, April 1982, p. 45.] In the summer of 1984, 68 percent of the certificates awarded by the American Institute of Banking in New York went to women.

While education has contributed to women's advancement, there is still work to be done. A 1980 survey comparing male and female first- and second-line bank managers, management trainees, and vice presidents showed that only 23 percent of the women, compared with 48 percent of the men, held college degrees. [Bryant, p. 45.] Women today are taking courses to improve their management and senior leadership skills. They are attending universities to learn more about the markets of the future, about finance and management, and to qualify for special professional designations. They are receiving training to enable them to use high technology methods of communication and information processing.

Employer-assisted educational opportunities in the banking industry are widely available. Several studies demonstrate the degree to which the financial services industry is committed to maintaining a workforce of employees who are skilled, knowledgeable, motivated, and productive. One hundred percent of the finance, accounting, and banking institutions responding to a recent survey conducted by the American Society for Training and Development (ASTD) provided educational assistance to their employees. A 1980 survey conducted by the American Bankers Association revealed that 95 percent of the top 100 banks paying major employee benefits provided tuition assistance. [Keith, p. 3.] Educational opportunities qualifying for aid ranged from upgrading typing and stenographic skills to graduate level courses. An upcoming joint study by the ABA and the ASTD will show that some form of tuition aid represented approximately 30 percent of the educational and training expenditures of the banks surveyed.

NABW Role in Educating Financial Services Women

For most of its history, NABW's members and their institutions have looked to the association to educate women for today's--and tomorrow's--managerial positions. In 1973 NABW responded to its assessment of the rapidly growing interest of women in business education and careers in financial services by establishing its Educational Foundation. Today the Foundation provides more than 14,000 industry employees each year with educational, career, management, and leadership development. Nearly all of these programs are paid for by the employers of the employees who attend them. The Foundation provides seminars, workshops, self-study programs, videotape workshops, and panel presentations. It offers a three-part Management Services Certificate Program which combines seminars, workshops, and self-study programs with on-the-job activites over a two-year time period. The NABW Bachelor of Science Degree program enables managers in financial services to earn a college degree in three to five years, much less time than required by traditional evening schools. Participants include officers and non-officers, with varied levels of banking and educational experience. The degree program, offered through two of the nation's outstanding academic institutions--Simmons College, Boston, and Mundelein College, Chicago--requires students to attend two 2-week management institutes each year for three years--six institutes in all. Since the degree program was officially launched in 1977, with financial assistance from the Carnegie Corporation of New York, more than 200 managers have graduated. A high percentage of participants have reported increased responsibility, promotions, and salary increases since enrolling in the program.

Educational Assistance Especially Benefits Lower-Level Employees

While employees at all occupational levels have taken advantage of employer-aided educational opportunities, Section 127 has special importance for employees at the lower, non-managerial level. Lower level employees have a narrower range of courses that can be considered "directly" related to their present job assignment than do employees at the managerial level. They would be hurt the most if Section 127 were not extended. A recent survey by the American Society for Training and Development found that 72 percent of the participants in educational assistance courses earn less than $30,000 per year and that lower-paid employees were more likely to participate in educational assistance programs than those at higher salary levels. Employees making less than $15,000 participated at a rate almost twice the amount for those who earned over $50,000. American financial services executives know that employer-assisted education is an effective way to upgrade the skills of their non-managerial employees. For example, in 1983, 75 percent of the employees receiving tuition reimbursements at a major American financial institution were clerical employees. In 1983, the average NABW member earned less than $30,000 and had yet to complete a college degree. If Section 127 is not extended, aid provided to employees to prepare them for new jobs and opportunities will be subject to income, social security, and federal unemployment taxes. This additional tax burden will fall particularly heavily on those with relatively low salaries who need the education most.

Revenue Gains Should Offset Revenue Losses

Employer-assisted education is the capital investment that the financial services industry makes in its future. It is an investment that pays off--for the companies in more highly skilled and productive employees and for the employees in new job opportunities and higher salaries. It is an investment that pays off for the country as well. Employees moving up the occupational ladder earn higher salaries and pay more taxes. Companies with highly trained, flexible, and educated employees are more productive, competitive, and profitable. Taxes collected from a well paid employee and a profitable company far offset any short-term gain realized by taxing employer-assisted education benefits. As John Hurley, Vice President, Chase Manhattan Bank, has stated, in testimony before the Senate Subcommittee on Taxation and Debt Management on July 30, 1984, "improved workforce productivity and lower unemployment costs far outweigh the meager revenue loss . . . that the Treasury estimates for employer educational assistance." [Fringe Benefits: Hearings Before the Subcommittee on Taxation and Debt Management of the Committee on Finance, United States Senate, 98th Cong., 2d Sess., p. 918 (1984) (testimony of John Hurley).]

Conclusion

The NABW strongly supports the permanent extension of Section 127. This tax provision encourages those in the private sector taking the initiative to provide America with a flexible and knowledgeable work force, ready to meet tommorrow's challenges. It will make a difference. Data from the National Center for Education Statistics of the U.S. Department of Education strongly suggest that Section 127, by not taxing employees for improving themselves, encouraged people to take advantage of employer aid for education and retraining in order to improve job performance and qualify for new jobs. Decreases as large as 50 percent in registrations for banking courses occurred when Section 127 was allowed to expire in 1984. [Hurley Testimony, p. 915.] Our industry and the nation as a whole, are facing rapidly changing demands for new workforce knowledge and skills. Our national policy must not discourage employees from seeking to meet that challenge.

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May 16, 1985

The Honorable Bob Packwood
Chairman
Senate Finance Committee
219 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Mr. Chairman:

On behalf of the National Association of Casualty and Surety Agents (NACSA), a national association representing 269 of the nation's leading commercial property/casualty insurance agencies and brokerage firms, I would like to direct your attention to an issue of mutual concern, the proposed taxation of employee benefits.

Our association and our overall industry recognize your sincere interest in this issue and are most appreciative of all that you have done to dissuade the Administration from including the taxation of employee benefits in their tax reform package. Since you and your colleagues are examining this issue in your review of the various tax "reform" proposals pending before your committee, we respectfully request that our comments be reviewed and made a part of the formal hearing record.

Mr. Chairman, as your committee reviews a number of tax "reform" proposals, we encourage you to examine the social policy objectives that employee benefit tax incentives provide to our economy. Under current law, Congress has in place tax incentives for employers who provide employees with tax-free benefits, such as group health, life, and pension benefits. This tax policy was enacted under the premise that extensive coverage of workers and their dependents was desirable social policy. We believe the public interest continues to be well served by this policy and should be retained as a part of the federal tax code.

The favorable tax treatment of employee benefits has encouraged the private sector to provide needed benefits, such as health, life, and disability insurance, pensions, and child care benefits. It also helps employers attract employees to their institutions. It is our fear that by eliminating these tax incentives, the following would occur: 1) employers would be discouraged from offering a broad range of benefits; 2) employees would be encouraged to drop benefits to avoid taxation; and 3) needed benefits would eventually be demanded from the federal and state governments by the majority of workers. Another potential adverse effect would be adverse selection, due to a decrease in the number sharing the cost of providing group benefits, the population then consisting of those most in need of utilizing these benefits.

Some officials in the Administration and in Congress have termed employee benefits "fringe benefits." We believe this understates the size and scope of these benefits, in terms of workers covered and the positive effect they have on our economy. This terminology leaves the impression that the loss to the U.S. Treasury outweighs the social and economic benefits, and that only the wealthy receive benefits. Contrary to that opinion, studies have shown that employer-based programs complement Social Security and Medicare; they reduce long-term demands on social welfare programs, thus strengthening the economy in the process. Additionally, these benefits enhance tax equity. Taxation of these benefits would be regressive since those most adversely affected would be our lowest paid earners, the elderly, and the disabled.

Few would refute that the majority of these benefits under consideration must be paid by someone. We believe it is better for these benefits to be provided by the private rather than by the public sector. Without tax incentives federal tax policy would encourage the absence of benefits for many citizens, threatening their financial security. Studies have shown that the federal government could never replace these benefits for an amount equal to or less than the dollars "lost" to the Treasury under our current tax policy. We encourage you to look closely at the serious, long-term consequences of taxing employer-provided employee benefits. NACSA believes it is in the best interest of the majority of working Americans and our economy to oppose the proposals to tax employee benefits which do not work to promote the social improvement and well-being of the American people.

Thank you for your consideration of our views on this important economic and social issue.

Sincerely yours,
Joan Albert Dreux
Joan Albert Dreux
Executive Director
Government Affairs

JAD:js

Statement of
John E. Lanz
Senior Counsel, Benefits
TRW Inc.
on Behalf of

the National Association of Manufacturers

Before the
Senate Finance Committee
U.S. Senate
on Proposals to Tax Employee Benefits

July 19, 1985

Mr. Chairman and members of the Senate Finance Committee, I am John E. Lanz, Senior Counsel, Benefits, TRW Inc., Cleveland, Ohio. I am appearing today in my capacity as a member of the National Association of Manufacturers' Employee Benefits Committee. Accompanying me is Sharon Canner, NAM's Director of Employee Benefits. The NAM is an organization of over 13,000 corporations of every size and industrial classification located in every state. Our members employ 85 percent of the workers in manufacturing employment and produce over 80 percent of the nation's manufactured goods. NAM also has an affiliation with 158,000 businesses through its Association's Council and the National Industrial Council.

Mr. Chairman and members of the Senate Finance Committee, we are pleased you are holding this hearing on employee benefits and giving this public policy area your time and attention. The following statement will provide an assessment of private employer benefits, comment on specific portions of the President's Tax Proposal, and offer some concluding remarks concerning stability in the administration and communication of employee benefit plans.

Employer-Provided Benefits

The number of workers covered by employee benefits is impressive. Of approximately 88 million persons engaged in non-agricultural occupations in 1983, 82 million had health insurance, and when family members are added, 162 million persons actually enjoy health insurance protection provided through employer plans. Coverage in other areas includes life insurance 72 million; disability insurance 51 million; dependent care 2 million; educational assistance 5 million; cafeteria or Section 125 plans 5 million; and pension plans 56 million. And by the end of 1984, over 19.4 million persons were participating in 401(k) plans. Private sector benefits provide American workers with a high degree of economic security assuring medical care needs can be met, income maintenance during short and long term disability, and adequate retirement income. In addition, individuals are encouraged to save for supplemental retirement income, and for other socially desirable purposes such as home purchase, educational expenses, and unforseen emergencies.

Beginning as early as 1921, the federal government, through the tax code, has encouraged employers to offer such benefits to workers. Over the years, an efficient and flexible system has evolved.

Because of this policy, the federal government, unlike its European counterparts, has not become the major provider of benefits. For example, the private sector has been encouraged, through tax incentives, to be the key sponsor of health protection which today costs approximately $100 billion a year. Less than one-third of that amount "costs" the government in the sense of foregone taxes. Should the government provide this protection, the replacement cost would be the full $100 billion.

In the retirement area, the three-legged stool of savings, employer-provided pensions, and Social Security form an important partnership in assuring income security. If incentives for saving to supplement retirement income are dramatically altered or other amendments are made to qualified plan rules, pressure to increase Social Security benefits can reasonably be expected. Recently, following statutory changes, Social Security was forecasted to be on firm financial footing. However, policymakers assumed the private retirement system would furnish individuals with a significant level of income.

Of an employee's total compensation package, which generally includes salary, paid absenses from work, vacations, employer contributions to government programs, and employer-sponsored health, life, and pension programs, only about 10 percent is accorded preferential tax treatment. Taxes are deferred, meaning they will be paid at a later date, on items such as retirement, disability insurance, and savings plans. This tax policy has encouraged savings and protected retirement income.

The current employee benefits system is a great success story, substantially because of a favorable tax policy with the employer, the employee, and the federal government working together. Let's not destroy it.

The President's Tax Proposal

The President's proposal, released on May 28, would make sweeping changes to employer-sponsored plans including changes in nondiscrimination rules, distribution rules, 401(k) and IRA contributions, excess plan assets, and the tax exclusion for health insurance. Our comments below address each of these individually.

o Uniform Nondiscrimination Rules for Retirement and Welfare Plans. To achieve plan qualification status, a new coverage test would have to be met. Exceptions include collective bargaining agreements, part time workers and those with less than one year of service. This new test would raise little revenue. It would however, raise labor and administrative costs and put nonunion companies at a disadvantage. The proposed nondiscrimination rules would require company wide plans, a matter of great concern to conglomerates in multiple lines of business located in various parts of the country. One company, for example, may operate gasoline stations, retailing establishments, and a packaging plant. Uniform plans would be cumbersome, expensive, and totally impractical to administer.

Companies have provided different benefit plans to accommodate varied lifestyles and needs of workers. These considerations are important in attracting a competitive workforce. Maintaining this flexibility is essential for the continued vitality of our nation's industry.

Certainly the nondiscrimination rules are a complex issue requiring careful study. We would be glad to work with you in resolving the technical details of any changes to such rules.

o Qualified Plan Distributions. The President's tax plan as released by the Treasury Department in May, proposes many changes affecting distributions from qualified plans, such as IRAs, 401(k) plans, and sheltered annuities. It is clear that the intent of these rules is to restrict distributions for retirement income to a stream of payments versus lump sums. Removal of hardship distributions and income averaging, as well as the imposition of various excise taxes are all part of this.

Treasury seems to take the view that the only socially desirable purpose for the tax-favored treatment of qualified plans is for retirement use.

Saving is vitally important in order to encourage long term investment in our nation's future. We observe, however, that in the United States, savings rates are far below that of other developed countries. Thus, we believe that it is socially desirable to encourage savings through vehicles such as tax-favored plans, thereby contributing to capital formation. Supplemental savings plans may at times have a lessor priority than savings for catastrophic medical expenses, home purchase, periods of unemployment or college tuition, but hardship withdrawals should not be so severly restricted as to totally discourage individuals from saving altogether.

o Excess Plan Assets. A 10 percent excise tax would be placed on the amount of assets reverting to an employer upon termination of a defined benefit plan. This tax, in effect, would be a penalty employers would have to pay as a result of the prudent management of pension plan assets. The tax would result in employers redirecting their investments to yield only that amount necessary to adequately fund plans and readjusting amoritization schedules. Not wishing to overfund, the net result might well be a tendency to underfund plans. So, this tax would make little sense in terms of assuring that pension benefits are adequately protected. Indeed it would thwart the most basic goals of our nation's retirement income policy. Further, such excise taxes would encourage defined contribution plans at the expense of defined benefit plans.

- Health Insurance Tax. The proposal would tax employees on the first $10 (for single coverage, $25 for family coverage) of the monthly premium paid by the employer. Workers might be encouraged to bargain for richer benefits without incurring greater tax liabilities. The proposal is regressive affecting those least able to afford it while at the same time doing nothing to encourage health cost containment. Seemingly, it's only advantage is its administrative simplicity. The floor tax is a revenue-raiser with no apparent social policy or tax reform objective.

- Contributions to 401(k) and IRA Plans. The proposal would limit an employee's yearly contributions to a 401(k) plan to $8000 offset by any contributions to an IRA. This restriction would discourage participation in 401(k)s. The employer dollar match and administration of the plan have been important factors in persuading individuals to save.

  Participation in 401(k)s is high, 81 percent compared to 17 percent for IRAs according to a recent survey of 250 corporations. As of May 1985, 20 million persons were participating in 401(k) plans according to the Employers Council on Flexible Compensation. Additionally, participation for rank and file workers has been higher than among those more highly compensated. Hardship withdrawals have been instrumental in encouraging this group to participate.

Difficult administrative problems would result under the Treasury's proposal as the employer would have no way of knowing how much a worker had contributed to an IRA. Certainly, the coordination issue would not become a problem were 401(k)s and IRAs to retain their current status under the IRS code. The needs of the individual worker coupled with the need to encourage capital formation for long term economic growth are important reasons to encourage the use of these salary reduction plans, rather than to severely limit their operation.

Conclusion

In conclusion we would like to offer some general comments on employee benefits legislation and regulation. The employer's ability to make long term planning decisions with some assurance that the rules will not be abruptly changed is important to the success of these programs. Since 1980, the Congress has passed three major tax bills making significant changes to employee benefit programs with implementing regulations yet to be issued in many instances. The tax proposals announced in May pose yet another set of potential changes. Consistency in employee benefits policy is essential if companies are to be encouraged to provide high caliber programs for American workers.

Aside from the benefit rule changes discussed here, there remain other major issues before the Congress, including vesting, integration, and portability (VIP), and an increase in the Pension Benefit Guaranty Corporation (PBGC) premium. Ample time is needed to tackle these areas before opening up an additional new legislative arena. The uniform nondiscrimination rules, for example, would require employers to test and, in many instances, restructure existing benefit plans for their workforces at considerable expense. The 401(k) and IRA integration would impose new recordkeeping requirements. It would seem prudent to impose a moratorium on employee benefits legislation to permit the issuing of long overdue regulations which seek to explain past tax legislation affecting benefits.

Overall, the goals of tax reform as articulated by the President's proposal are to simplify and grant equity to the greater majority and yet remain revenue neutral. In the employee benefit area the proposed changes would add complexity and expense. With the exception of the health floor tax, no significant revenue would be raised. In view of this, we urge you to consider carefully how such changes would seriously damage a system that now works well in providing for the economic security needs of American workers.

STATEMENT SUBMITTED
ON BEHALF OF THE
NATIONAL SMALL BUSINESS ASSOCIATION
TO THE
SENATE COMMITTEE ON FINANCE
HOLDING HEARINGS ON
THE IMPACT OF THE PRESIDENT'S TAX REFORM PROPOSAL ON EMPLOYEE BENEFITS

JULY 19, 1985

This testimony is being submitted on behalf of the National Small Business Association (NSB), a multi-industry trade association representing approximately 50,000 small business firms nationwide.

We appreciate the opportunity you have given us to submit to you some of the views of small business regarding the President's Tax Plan and the effect the employee benefit provisions may have on small businesses.

So far as retirement plans go, small business places very heavy emphasis on the Social Security system. The report of President Reagan on "The State of Small Business", transmitted to the Congress in May of 1985, at page 259, shows that in 1983 only 14% of workers in firms employing 1 to 24 were covered by a pension plan. This compares with 72 percent coverage in firms with 500 or more. Furthermore, the pension coverage is not being expanded since the ratio four years earlier was 15 percent. The reasons are fairly clear. The rules and requirements for establishing an employer pension plan are extremely complex, and the most complex rules, such as the multiple plan limits and top-heavy plan rules, fall most heavily on small business. We pray for simplification.

In that same report, the coverage of small business workers under multi-employer plans is shown to have dropped from 32 percent four years ago to only 23 percent today. In this instance it is the heavy liability imposed on withdrawing employers by the 1980 law that is undoubtedly partly responsible for the failure of small business to participate more frequently in these valuable programs.

Finally as a general matter, it might be observed that Congress has been making ever more frequent changes in the rules relating to pension and profit-sharing plans. The rules changed significantly in 1982 and again in 1984 and we are now faced with the possibility of yet another change in these rules. Long-range programs, aimed at providing retirement income security, operate much more efficiently under stable economic conditions and tend to be unattractive when conditions are changing rapidly. Whatever is done in the pension area, we would hope that Congress will make the necessary changes and then let the coverages operate on their own for a while. Small business in particular needs some respite from the continual change that has characterized pension regulation recently.

There are two specific proposals relating to retirement benefits included in the President's tax proposal which we believe would be detrimental to small business. In section 14.04 of the President's proposal, it is noted that "Calculation of the overall limit imposes a significant burden on employers and plans and indeed may be the primary source of complexity in the retirement plan area. It requires an employer to maintain significant records for many employees and to coordinate the contributions and benefits under all of its tax-favored plans. The overall limit also creates a disincentive for employers to establish both defined contribution and defined benefit plans." The proposal, however, is to eliminate these confusing and complex rules only for plans which are not "top-heavy". For top-heavy plans, the existing overall limits would continue to apply.

In the analysis, it is observed that "Eliminating the overall limit for non-top-heavy plans would eliminate a significant source of complexity and thus should promote the adoption of tax-favored plans." The top-heavy rules do not apply to most major employers, but they impose a fearful burden on small business. To eliminate these sources of complexity only for non-top-heavy plans would promote the adoption of tax-favored plans only by big business. Small business would be apparently left with the present top-heavy rules and the present complex overall limit and would have a significant disincentive to establish retirement plans. We believe this inequity should be eliminated. The top-heavy rules and the overall limits should be eliminated for both large and small employers.

A considerable portion of the President's tax proposal is related to 401 (K) plans. These would have been eliminated in last November's Treasury proposals but apparently pressures from major corporations have led the President to impose restrictions instead. The "State of Small Business", at page 271, shows that the 401 (K) plan is not very useful to small business. Only 1 percent of wage and salary workers in firms employing 1 to 24 people are covered by a 401 (K) plan, as compared with 17 percent of workers in plans of companies with 500 or more workers. This pattern is likely to continue and large companies are likely to be able to offer and sponsor 401 (K) plans, cafeteria plans and flexible benefit programs, but the smaller business will be unable to afford such plans, to administer them, or to understand the complex regulatory requirements. The more attractive these plans become, the greater the discrepancy between the benefits offered by big business and small.

In yet another section (12.06 of the President's proposal), a new employee stock ownership trust would be made available. Here at page 316, the proposal states "An employer with 15 or more employees that borrows funds from an unrelated lender to purchase outstanding employee securities...would be permitted to deduct principal payments made each year with respect to the indebtedness...". We find this limitation of special tax features only to employers of sufficient size unacceptable. If a major corporation is able to install an employee stock ownership trust for his employees and gain a tax advantage, why should the employer with fewer than 15 employees be denied that tax treatment solely because the number of employees is too small?

The proposals on health and welfare plans would affect far more small businesses. The "State of Small Business" indicates that approximately 39 percent of wage and salary workers in firms employing 1 to 24 individuals are covered by health insurance, as compared with 85 percent of the workers in firms with 500 or more. Here the reason for the discrepancy in coverage probably relates to inability of the small firms to pay the heavy costs involved in the generous health plans that are now considered the standard.

The Administration's latest version of the employee health tax--taxing the employee on the first $10 for individual coverage and on the first $25 if family protection is elected--a so-called "floor"-- is a floor that is dangerous. Since it would initially cost each employee relatively little, it has superficial appeal. But experience shows that once a mechanism like this is in place, the price can go up and up. The result will be less comprehensive protection for those who now have it, and less chance of securing protection for those who want it.

Congress has successfully, over many decades, encouraged the private sector to construct a broad, effective system of employee benefits. To change directions now, at a time when government programs for medical care are being squeezed, would be very wrong. Although the government can cause the scope of group health insurance protection to shrink, the need for that protection will not change.

The chief problems with health and welfare coverages, including group life insurance, will be related to the new and complicated non-discrimination rules that would apply. These rules would impose far stricter limits on small business than on big business, since the prohibited group would include 1 percent owners, the highest compensated 10 percent and any of their family members. Many small firms employ family members, so that, at the outset, the prohibited group is likely to be far bigger than the non-prohibited group. These non-discrimination rules are extremely complicated and impractical.

In particular, there is a new requirement that for educational assistance, dependent care assistance, qualified tuition reduction, company meals and employee discounts, the employer must maintain a record of the amount provided for the prohibited group and the non-prohibited group and limit prohibited group participants to 125 percent of the average amount provided for a non-prohibited group participant. This requirement will make these coverages almost completely impractical for the small business. Small business supports fully the concept that these valuable programs should be offered on a non-discriminatory basis. We do not believe, however, that it is necessary for the Internal Revenue Service to require small businesses to conduct all sorts of tests in order to prove that their plans meet the

IRS tests while big business meets the test by such a wide margin that the data maintenance and annual calculations are completely unnecessary.

This is an unjustified burden on small business. If Congress is really concerned about discrimination, the simplest thing to do would be to require that all full-time employees be covered by any plan. Let the non-discrimination rules apply to plans where all employees are not covered.

Finally, there is a special "concentration test" applying to group legal, cafeteria plans, educational assistance, dependent care, and "each fringe benefit excluded from income". This test would require that the contributions for the highest-paid 20 prohibited group members must not exceed 25 percent of the total contributions. This is clearly an easy test to meet for the largest employers in the country. It is clearly an impossible test for a group with 20 employees, of whom 15 are prohibited group members by reason of family status, etc.

By and large, the new rules proposed for non-discrimination may well appear reasonable in theory. In practice, we can foresee, however, a considerable degree of difficulty on the part of small business in maintaining the records necessary to make and meet these tests. Indeed, we see the tests being designed in such a way that the smaller the business, the more difficult it is to meet the test. We deplore standards of this sort that fall most heavily on the smallest businesses.

By summary, small business relies very heavily on Social Security and many small businesses have no other benefit plans. If retirement plan rules were simple, perhaps more small businesses would make supplemental pensions available to their employees. We support all efforts to simplify these rules. We do endorse fully the concept of non-discrimination. We believe this desirable end can be achieved, however, with far less complexity and far less disincentive to install such plans for the small business.

Thank you.

The City of New York

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Refer to Registry No. ________

July 30, 1985

STATEMENT OF THE

NEW YORK CITY
TEACHERS' RETIREMENT SYSTEM

ON THE

ADMINISTRATION TAX REFORM PROPOSAL

The Teachers' Retirement System of the City of New York (the "Retirement System") is pleased to have this opportunity to comment on the Administration's tax reform proposal. The Retirement System funds and administers two major retirement plans primarily for the benefit of teachers and related employees of the New York City public schools: (1) a defined benefit pension plan, and (2) a tax-deferred annuity program (the "TDA Program"). We are extremely concerned about the serious impact that many of the proposals would have on our members, including severely discouraging them from participating in retirement programs and reducing opportunities to maintain needed levels of retirement income. Our comments may be briefly summarized as follows:

1. The special "catch-up" contribution limits for tax-deferred annuities should be retained to reflect the contribution patterns of employees who are not highly compensated.

2. The proposed withdrawal restrictions would have a devastating effect on participation in tax-deferred annuities and should be rejected.

3. The proposed 20 percent tax on withdrawals prior to age 59-1/2 is punitive, would be borne by low and middle income persons, and should be rejected or at least modified.

4. The current ordering rules for contributory plans and the 3-year rule for annuity distributions should be retained.

Following is a description of the Retirement System and the TDA Program, and a discussion of the above comments.

I. The Teachers' Retirement System and the TDA Program

The Retirement System covers over 76,000 teachers, principals, assistant principals, college professors who elect to participate, teaching assistants, and school secretaries of the New York City public school system. Under almost all definitions our people are not highly compensated. The average annual salary in 1984 for a New York City public school teacher was about $28,000, and the maximum such salary was about $34,000. Only a small fraction of all participants in the Retirement System -- generally principals of junior and senior high schools -- earned over $45,000 in 1984, and no participant earned more than $60,000.

The TDA Program is maintained in accordance with section 403(b) of the Internal Revenue Code by the Retirement System on a salary reduction basis; New York City public school employees may elect in advance to have part of their compensation set aside for retirement. The TDA Program functions as a supplemental defined contribution plan; participant contributions plus earnings are primarily used to supplement fixed pension benefits at retirement.

A very real practical problem faced by New York City school employees is the difficulty of affording contributions to the TDA Program to assist their own retirement. Public school salaries are extremely modest in comparison to private sector compensation, and the cost of living in New York City is relatively high. Nevertheless, support for the TDA Program is strong, and over 25,000 persons -- about one-third of those eligible -- make contributions. While the average contribution in 1984 by those who did contribute was a very modest $3,944, this money represents important retirement savings for TDA Program participants. The average TDA Program account balance at the end of 1984 was $26,338. While this sum may represent an extremely modest career accumulation in comparison to defined contribution plans in the private sector, we would emphasize again that these amounts help provide extremely valuable retirement security to New York City public school employees.

II. The Special "Catch-up" Contribution Limits For Tax-Deferred Annuities Should be Retained To Relect the Contribution Patterns of Employees Who Are Not Highly Compensated

Even prior to ERISA, contributions to tax-deferred annuities were subject to a special "exclusion allowance" limitation (20 percent of includible compensation, times years of service, minus all contributions in prior years). ERISA superimposed on this limit the general limitations (sec. 415) for qualified plans (including a 25 percent of taxable compensation limit). For persons who can afford regular section 403(b) contributions, the 20 percent exclusion allowance is usually smaller than the general 25 percent limitation.

However, the cumulative nature of the exclusion allowance does help low to middle income persons who may not be able to afford consistent contributions. When ERISA was enacted, Congress recognized that "certain categories of employees covered under section 403(b), such as teachers, typically have a pattern of low contributions in the early stages of their careers, with relatively high 'catch-up' contributions made late in their careers." H.R. Rep. No. 1280, 93d Cong., 2d Sess. 345 (1974) (ERISA Conference Report). Accordingly, Congress enacted "catch-up" exceptions to the general section 415 qualified plan limitations, which allow limited relief only if a participant's exclusion allowance has not been used in prior years.*/ Catch-up elections were made by in 1984 by 1,425 participants in the TDA Program; in 1,423 of these instances, or 99.86 percent of the time, the additional catch-up contribution was limited by statute to a maximum of $3,200.

The "catch-up" rules recognize basic differences between retirement plans for corporate or other private sectors employees and tax-deferred annuities for public sector employees. Contributions in the private sector are often made automatically for employees, and often may be viewed as an added bonus. In contrast, before contributions are made to the TDA Program and many other tax-deferred annuity programs, a participant must agree to reduce his or her already modest salary by the amount of the contribution. What was true in 1974 is equally true today: younger participants are generally unable to make section 403(b) contributions. We would emphasize that the catch-up rules do not permit contributions in excess of the exclusion allowance, which is usually a more restrictive limit than the general limits for qualified plans.

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*/ The catch-up elections are set forth in Code sections 415(c)(4)(A) and 415(c)(4)(B). We do not view the third election of Code section 415(c)(4)(C) as a catch-up election, because this "(C)" election simply has the effect of applying the general section 415 limits to the participant (including the combined plan limits of section 415(e)).

We see no reason to repeal the catch-up rules. The limits on contributions to tax-deferred annuities are not more favorable than the limits for private sector plans; the section 403(b) limits, including the catch-up rules, are tailored to the needs and savings patterns of lower paid participants. These rules were and are sound policy and have now been in effect for almost a decade. Participants have planned their retirement savings on the assumption that catch-up rules will continue to be available. Repeal would have the strongly regressive effective of penalizing public sector employees who are unable to contribute in the early part of their careers.

If there is some manner in which highly paid participants in other tax-deferred annuity programs are able to use the catch-up rules to make contributions perceived to be excessive, we urge that any such problem be addressed with surgical precision to avoid jeopardizing the retirement security of low and middle income persons. For example, consideration could be given to a proposal to make the "catch-up" rules inapplicable to persons with annual compensation above $60,000 (twice the section 415(c)(1)(A) limit).

At a minimum, we see no reason why the election in Code section 415(c)(4)(C) -- to apply the general section 415 rules for corporate plans -- should be eliminated. This election does not permit contributions in excess of 25 percent of current taxable compensation, and that limit is appropriately reduced where a defined benefit plan is also maintained. Also, the elimination of this election is not necessary to promote uniformity or simplification of the law in this area. Accordingly, at a minimum, the election in Code section 415(c)(4)(C) should be preserved regardless of any other action which may be taken in this area.

III. The Proposed Withdrawal Restrictions Would Have a Devastating Effect on Participation in Tax-Deferred Annuities and Should Be Rejected

The Administration would prohibit withdrawals from tax-deferred annuities prior to age 59-1/2, except in cases of death, disability, or separation from service. For example, a teacher age 30 who contributed to the TDA Program and remained in service would be completely unable to withdraw any amounts for almost 30 additional years, regardless of any supervening financial emergency or hardship.

We agree that tax incentives for retirement savings should be directed to arrangements where the funds are likely to be actually used for retirement purposes. The TDA Program strongly discourages in-service withdrawals by prohibiting further contributions for two years after a withdrawal is made. However, experience has shown that the potential ability to withdraw funds is an essential factor in encouraging participation, and that, without reasonable access, most low or middle income persons will be afraid to sacrifice their current income for retirement purposes.

Accordingly, we are concerned that the proposed prohibition on in-service distributions prior to age 59-1/2 would devastate participation in tax-deferred annuity programs that do not benefit highly compensated persons, such as the TDA Program. Although highly coupensated persons are likely to have other funds available to meet emergencies, the resources of teachers and other participants in the TDA Program are often much more limited. Thus, while it may be intended to increase the amount available for retirement, this proposal would in practice lead to significant reductions in retirement savings by those persons who are likely to have the greatest need for funds. This would be the case even though the clear majority of our participants use the TDA Program primarily for retirement purposes. We strongly urge that this proposal be rejected as contrary to sound retirement income policy.

IV. The Proposed 20 Percent Tax on Withdrawals Prior to Age 59-1/2 is Punitive and Would Be Borne By Low and Middle Income Persons

The Administration proposes a 20 percent tax on withdrawals or distributions from tax-deferred annuities or qualified plans prior to age 59-1/2. Thus, if the above prohibition on in-service withdrawals prior to age 59-1/2 were also enacted, this tax would apply to termination of service distributions prior to age 59-1/2 that are not rolled over. It is stated that this tax "is not designed as a penalty, but rather to recoup some portion of the unintended tax advantages that can be obtained by using tax-favored funds for nonretirement purposes." However, a 20 percent rate of tax would be punitive for participants in the TDA Program.

In practice, low and middle income workers would be the ones to withdraw amounts "prematurely" and bear the brunt of the 20 percent tax. Low and middle income workers are much less likely to have other funds available to to satisfy a financial emergency. Further, for most of these people, the 20 percent tax would far exceed the advantage of tax deferral. Even assuming almost 20 years of tax deferral at a constant 10 percent rate of earnings, a person in the 15 percent tax bracket -- which is where many TDA participants would fall under the Administration proposal -- would be better off with a taxable savings account.

Existing law already discourages non-retirement withdrawals from tax-deferred annuities, and other provisions of the Administration proposal would heighten this effect. For example, withdrawals from tax-deferred annuities do not qualify for 10-year averaging or other special tax treatment, and thus are likely to produce a substantial increase in tax if added to other income when the participant is not retired. Also, the Administration would eliminate the relatively small relief that may result under the general income averaging rules. Under these circumstances, we are confident that most participants will not withdraw funds for current use unless such use is of major importance to them.

In summary, the clear majority of our participants use TDA Program funds for retirement purposes, and we see no reason for the imposition of a penalty tax on withdrawals from tax-deferred annuities. The effect of such a tax would be to discourage retirement savings and reduce the retirement security of low and middle income workers. However, if forced to choose between (1) an absolute prohibition or (2) a tax on withdrawals prior to age 59-1/2, a tax would appear to be the preferable approach. Even a regressive penalty would be preferable to an absolute prohibition, as some ability to recover funds in the event of an emergency is essential if younger teachers (and even many middle-aged teachers) are to participate. If a special tax is imposed on "premature" withdrawals, we believe that the rate of tax should be reduced to 10 percent, at least for persons who are not key employees (as defined in section 416(i)(1) of the Code). For a typical TDA Program participant in the 15 percent bracket under the Administration proposal, a 10 percent additional tax would more than offset any advantage from even 10 years of deferral (assuming a steady 10 percent return).

V. The Current Ordering Rules for Contributory Plans and the 3-Year Rule for Annuity Distributions Should Be Retained

The Administration would revise the well established ordering rules for the taxation of distributions from pension plans that provide for after-tax employee contributions, such that initial withdrawals would be treated first as a distribution of taxable income rather than as a tax-free return of employee contributions. Because the pension plan maintained by the Retirement System is financed in part by required contributions from participants, this proposal would adversely affect teachers and other public school employees of New York City. Most of our participants are currently able to withdraw from the pension plan a fraction of their own contributions upon retirement; those amounts are actuarially determined to be not necessary to provide the basic pension the participant has earned. For example, in 1984, 2,740 participants withdrew on average the modest sum of about $7,300. If these initial amounts are taxed it will serve as a disincentive for persons to contribute for their own retirement, even though a greater portion of the subsequent annuity payments could be recovered tax-free.

We agree with the Administration that, if these ordering rules are changed, a transition rule should grandfather prior employee contributions. Unfortunately, such a rule, while clearly fair to participants, would create immense complexity in the recordkeeping area. The amounts of both "old" and "new" employee contributions would have to be kept separately, and this complexity would significantly increase administrative costs. We are also very concerned that participants will experience great difficulty in understanding the complex tax scheme that would result.

The Administration also proposes to repeal the so-called "3-year recovery rule," which allows a participant receiving annuity distributions from a contributory plan to treat initial annuity payments as a tax-free return of his or her own contributions, provided that all of the participant's after-tax contributions will be recovered within three years after retirement. This rule simplifies the tax treatment of annuity distributions where it applies, and its repeal would require detailed calculations of the excludible portion in all cases. Further, the rule provides a modest form of tax relief in the first few years following retirement, and thus assists persons during this often difficult transition period.

Our more fundamental objection to these two proposals is that they are unnecessary and inappropriate changes to existing law. Although a significant revenue gain is predicted in the initial 5-year period, we believe that over the long term these proposals would gain little revenue, and that what the Administration is measuring is primarily a difference in timing. Both proposals would not subject additional amounts to tax; each essentially would require that the same tax be paid sooner rather than later.*/ We recognize that revenue concerns (even short-term ones) need to be considered at this time. However, we respectfully submit that, in this limited area, they do not provide a reasonable basis for tampering with well-established tax rules that primarily affect Americans of modest means.

* * *

We sincerely appreciate the opportunity to comment on these proposals of serious concern to the New York City Teachers' Retirement System and its members. We would again urge that any measures designed to curtail perceived abuses by highly compensated persons be carefully crafted to avoid jeopardizing the retirement security of persons of modest means.

If there are any questions or if further discussion of these matters is desired, please do not hesitate to contact Louis Mazawey or Douglas Ell ((202) 857-0620) of Groom and Nordberg, Chartered, our counsel in this area.

Sincerely,

Wallace F. Sullivan
Executive Director

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*/ We are also concerned with the concept that, if the new rules would not allow you to exclude your own after-tax contributions from the benefits you receive during your lifetime, your estate would be entitled to the exclusion. This after-death deduction will be of relatively little value to the vast majority of participants in our program and their beneficiaries.

COMMITTEE ON FINANCE, U.S. SENATE

COMPREHENSIVE TAX REFORM HEARINGS -- EMPLOYEE AWARDS

WRITTEN TESTIMONY OF O. DON OSTLER
OF THE O. C. TANNER COMPANY
ON EMPLOYEE AWARDS

My name is O. Don Ostler. I am President and Chief Executive Officer of the O. C. Tanner Company of Salt Lake City, Utah, on whose behalf this testimony is presented.

The President's Tax Proposal would repeal the exclusion for employee awards. We urge the Congress to modify the President's Proposal by maintaining the exclusion for employee recognition awards within reasonable limits.

BACKGROUND AND EXPERIENCE

For over 50 years the O. C. Tanner Company has been an innovator and leader in the design, manufacture, and marketing of employee recognition awards. It serves over 10,000 companies throughout the United States each year, including 49 of the Fortune top 100 companies. Each year the Tanner Company manufactures and supplies over 2,500,000 awards.

The employee recognition award industry is highly competitive. Each company strives to be aware of what is happening in the entire industry. I have been personally involved in the employee award industry for 28 years. For the past 11 years I have been President of the O. C. Tanner Company and I have been Chief Executive Officer for the past 4-1/2 years. I am deeply involved and generally familiar with the employee recognition award industry.

THE PURPOSE AND NATURE OF EMPLOYEE AWARDS

The purpose of employee awards is to recognize and encourage individual employee length-of-service, safety achievement, and productivity. It has become a customary practice throughout American industry to honor these employee achievements by making awards to individual employees of items of tangible personal property, usually of a symbolic nature.

Employee achievement awards serve several employer purposes. Giving an employee recognition award is an effective way to say "Thank you" and to express appreciation for achievement. An employer designs the program, honors the employee at a presentation, and reaps the employee goodwill and heightened motivation and loyalty generated by this type of expression of gratitude. Typically, an employer has not "promised" the award; hence, many regard these items as "gifts" to employees. I know of no instance where an award program has been the subject of collective or individual bargaining with employees.

Employee longevity, loyalty, safety, and efficiency are all enhanced by the practice of making employee recognition awards. The results of recognizing employee achievement constitute a small but significant benefit for the entire American economy.

The presentation of tangible employee achievement awards also enhances the image and community goodwill of the employer. An employer customarily uses an item of tangible personal property because --

(a) The employer can build into the item its name, logo, or symbol, thereby achieving an important employer advertising objective;

(b) The employer can create an award that reflects its corporate character and supports its unique cultural goals and values, such as quality, service, and loyalty;

(c) The employer can use an item which by its nature is likely to be worn, carried, or displayed, and into which the employer can custom build beauty and attractiveness; and

(d) The employer can have a reasonable expectation that the item is likely to be retained, worn, and carried or displayed by the employee.

By careful selection and custom preparation of a tangible recognition item, the employer will have acquired a valuable and long-lasting advertising location on the person or in the home of the employee.

Length of service awards are typically given only once every five years after the first five years, and are given under programs that cover all full-time employees of the employer on a nondiscriminatory basis. Safety achievement awards are typically limited to a unit or division of an employer -- e.g., all truck drivers or lathe operators -- and are given only to those who achieve a meaningful period of service or production without accident or injury -- e.g., 100,000 accident free miles or 5 years without injury. The typical productivity award recognizes a greater human contribution by the employee to the work place or the work climate -- e.g., a friendly bank teller award, a courteous salesclerk award, a zero defect award, etc.

CONGRESS HAS ENDORSED EMPLOYEE AWARDS

Recognizing employee achievement is a well established business custom. An employer provides recognition, not out of "disinterested generosity," but rather to enhance employee loyalty and performance and to promote and advertise the employer's image and goodwill among employees and the community. More than two decades ago, Congress determined that this customary practice is good for American industry, and enacted tax laws intended to foster its continuance. In 1981 Congress reemphasized its objective and updated the statute to reflect inflation and other technical changes.

Under section 274(b) items of tangible personal property awarded by an employer to an employee by reason of length of service, productivity, or safety achievement are generally deductible up to $400 in the case of individual awards, and up to $1,600 in the case of awards under a qualified, nondiscriminatory plan, as long as the average cost of items under the plan does not exceed $400. Although there is no express provision in the Code excluding employee awards from income, the Revenue Service has not as a practical matter sought to tax deductible employee awards. Last year the Senate passed Senator Garn's proposal, supported by the Treasury, to provide an explicit exclusion, subject to various restrictions, for deductible traditional employee awards, and to make technical improvements. This provision was not adopted in the Conference.

THE PRESIDENT'S PROPOSAL

Chapter 3.05 of the President's Proposal would include the employer cost of all recognition awards in the gross income of the employee. This proposal is unsound and should be rejected.

EMPLOYEE AWARDS SHOULD NOT BE TREATED AS GROSS INCOME TO THE EMPLOYEE

Employee recognition awards should not be taxable because --

(a) recognition awards are made to employees principally for the benefit of the employer, and

(b) the vast majority of employee awards are so customized that they cannot be sold in the marketplace and have little economic value to the employee.

When a recognition award consists of custom made jewelry using gold or other precious metals and jewels, the "melt down" or salvage value of an employee award is so slight, because of the small quantity of precious metals or jewels involved, that the item has no more than nominal economic value to the recipient. Nor can an employee resell or pawn his employer logo pin or tie tac for more than a nominal amount. Accordingly, the value to the employee is too small to make it administratively feasible to tax employee awards.

On the other hand, providing a recognition award to an employee generates considerable intangible value. It builds employee morale, stimulates pride, strengthens self-esteem, causes an employee to feel wanted and recognized by his employer, and provides positive emotional support in the employement relationship. Though these human benefits are very important, such values are not cash equivalents to the employee and are not taxed under our revenue system.

RECOMMENDATION

We urge the Committee to support the approach taken in Senator Symms' bill, S. 743, a copy of which is attached hereto. Under this bill reasonable limits would be placed upon the extent to which employee awards could be excluded from the gross income of recipients. It would provide an exclusion from gross income equal to the lower of the cost to the employer or the value to the employee of up to $250 in the case of an individual award and up to $1,000 in the case of a qualified plan award. (It is important to bear in mind that items constitute qualified plan awards only if their average cost does not exceed $400, so the $1,000 excluson could apply only to a few such awards under any particular qualified plan. All qualified plans must be nondiscriminatory with respect to both eligibility and benefits.)

All segments of the employee award industry are united in support of the Symms' bill, which makes no distinctions with respect to the kind of tangible personal property used to make employee awards. (Intangible items, such as gift certificates or vacations would continue to be fully taxable if given by an employer to an employee.) The Symms' bill represents a reasonable middle ground between the position of the President's Tax Proposal, which would repeal the exclusion entirely, and the traditional practice of both industry and the IRS, which has been not to treat deductible employee awards as taxable. In addition, the Symms' bill would require employers to file adequate reports to assure that any employee awards not meeting the deduction and exclusion standards of the Code would be included in taxable income.

Of course, it might be appropriate to add certain clarifying provisions to any legislation that is eventually enacted, to prevent abuse and to correct technical problems. Thus, it might be appropriate to provide for the taxation of any item that constituted disguised compensaation and to limit the exclusion for employee awards to length of service awards that, after the first five years, are given no more frequently than once every five years. In the case of safety achievement and productivity awards, it might be appropriate to limit the exclusion to awards given no more frequently than once a year. Section 828 of the Deficit Reduction Act of 1984 as passed by the Senate last year contained technical provisions that would have clarified certain problems under current law. These provisions could be considered again in the course of enacting legislation this year.

CONCLUSION

The Symms' bill represents a fair and reasonable balance between the Treasury's desire to prevent abuse and the long-standing Congressional policy of encouraging recognition of employee achievement in order to cement better relations between employers and employees. Because the Revenue Service has never sought to treat deductible employee awards as taxable income to recipients, no revenue loss in fact would be caused by enacting the Symms' bill. Indeed, there might be an increase in revenues caused by establishing a clear rule that taxes any portion of an individual award that exceed $250 and any portion of a qualified plan award that exceeds $1,000. The entire employee award industry is united in its support for the Symms' bill, and we urge this Committee to support and adopt it.

We will be happy to supply any information that may be useful to the Committee, or to work with the staff to solve any technical problems that may arise. Thank you very much.

Testimony of Philip D. Morrison of
Ivins, Phillips & Barker, Washington, D.C.

on behalf of
Oberlin College, Oberlin, Ohio

Before the Senate Finance Committee
For Inclusion in the Hearing Record of
July 1[illegible], 1985
on the

IMPACT OF THE PROPOSED UNIFORM NON-DISCRIMINATION RULE ON SECTION 117(d) TUITION REDUCTION PLANS

My name is Philip D. Morrison. I am a member of the law firm of Ivins, Phillips & Barker located here in Washington. I represent Oberlin College. My remarks today deal with a single issue: the impact of the proposed uniform non-discrimination rule for all tax-favored fringe benefits (Chapter 3.04 of President Reagan's Tax Proposals) on tuition reduction plans under Internal Revenue Code § 117(d). I am also authorized to tell you that the Great Lakes Colleges Association, a group of 12 colleges and universities,*/ The Associated Colleges of the Midwest, a group of 13 colleges and universities,**/ Bucknell University, Gettysburg College, Haverford College, Swarthmore College, Trinity College, and Williams College wish to associate themselves with my remarks today and generally support Oberlin's position on this issue.

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*/ Albion College
Antioch University
College of Wooster
Denison University
De Pauw University
Eastham College
Hope College
Kalamazoo College
Kenyon College
Oberlin College
Ohio Wesleyan University
Wabash College

**/Beloit College
Carlton College
Colorado College
Coe College
Cornell College
Grinnell College
Knox College
Lake Forest
Lawrence University
Macalester College
Monmouth (Ill.)
Ripon College
St. Olaf College

The issue addressed in these remarks is narrow but important. Its importance derives not from a large revenue impact -- indeed, the revenue impact is tiny -- but from an enormous relative dollar impact on a few individuals' tax liabilities: should the non-discrimination proposal in President Reagan's reform package pass unchanged some college employees could see a tax increase of 25% or more without either fairness or simplicity, two of the three avowed goals of the President's reform effort, being advanced in the least.

Tuition reduction plans under § 117(d) generally offer free or reduced tuition to dependents of employees either at the granting institution or at another institution. These programs have been in existence for decades and were intended not only to provide a significant employee benefit but also to encourage higher education in general. There are as many different plans and benefit levels as there are colleges who offer the benefit. Oberlin College, for example, offers all children of faculty and administrative and professional staff either full tuition at Oberlin or a scholarship equal to 50% of Oberlin's tuition at another college. Employees who started work at Oberlin when prior programs going back to 1957 (which offered 80% and 100% benefits) were in effect are allowed those higher benefits under "grandfather" provisions.

My firm was hired by Oberlin shortly after the 1984 Tax Reform Act became law to help the college redesign its tuition reduction plans to comply with that Act's non-discrimination requirement. As the members of this committee will recall, the 1984 Act not only codified the tax-free status of tuition remission/tuition grant programs but also conditioned the continued tax-free status of these benefits on compliance with a non-discrimination rule. This new requirement just became effective July 1, 1985 with the start of the 1985-86 school year. Compliance with the 1984 Act's rule regarding non-discrimination, assuming that rule is reasonably interpreted in future Treasury Department regulations, is costly but possible. Despite the lack of regulations, such compliance is being planned for by affected colleges and universities right now just as Oberlin, with what little guidance I have been able to provide, is planning.

Chapter 3.04 of the President's tax proposals, however, obliterates the just enacted anti-discrimination rules of the 1984 Act and proposes a new and very different uniform non-discrimination rule for all fringe benefits, including tuition reduction plans. For tuition reduction plans, compliance with the new non-discrimination rule in the President's proposal would be virtually impossible. Indeed, most colleges' plans would not comply unless "prohibited group" members (*i.e.*

highly-paid employees) are precluded from having the same level of tuition benefits as lower-paid persons or some prohibited group members are precluded from the plan altogether. This perverse result of a non-discrimination rule actually causing discrimination is the product of a failure to recognize the basic nature of a tuition reduction benefit.

Current law (since the 1984 Act) would test a tuition reduction plan for discrimination on the basis of eligibility. Thus, a benefit would be non-discriminatory if it was available to all employees on substantially the same terms. President Reagan's proposal would replace this with a utilization test, measured by looking both at (1) relative percentages of "prohibited" and "non-prohibited" group employees actually receiving a benefit under a plan, as well as by looking at (2) the average dollar amount of benefit employees in each group actually use. Under the first test, the relative number of prohibited group members (generally the top 10% of employees by compensation) actually receiving benefits could not exceed the relative number of non-prohibited group members actually receiving benefits by more than 125%. Under the second test, the average dollar amount of benefit provided prohibited group participants could not exceed 125% of the average dollar amount expended for non-prohibited group participants.

While these new utilization tests might make sense for some types of fringe benefits which employees of all ages can use, they make no sense at all for tuition reduction benefits. First, by their very nature, college tuition reduction benefits will be utilized only by employees over 40 since few, if any, younger employees will have college-age children. Employees over 40 tend to be more experienced in general, and therefore, tend to be more highly compensated.*/ Utilization of tuition reduction benefits, therefore, will almost always appear to discriminate in favor of more highly compensated employees. Since older, more experienced, and more highly-paid employees are the ones most likely to utilize the benefit, it is virtually impossible to devise a program under which younger, less experienced, and less highly-paid employees actually receive even roughly the same level of benefits. Younger, less highly-paid employees simply cannot send their three year olds to college. To avoid "discrimination" under this sort of utilization test many higher-paid employees must simply be deprived of the benefit.

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*/ This is especially true when union employees (who, at private colleges, tend to be non-faculty, non-professional) are excluded from the pool of employees being tested. The Reagan proposal quite properly excludes union employees whose union actually bargains over a tuition grant benefit from being counted for discrimination test purposes, on the theory that collective bargaining should determine union members' compensation and if a union desires to bargain away a benefit in exchange for something else, that decision should not be impeded by federal tax law.

Testing for discrimination on the basis of average dollar amounts of benefits received as well as on employee utilization exacerbates this effect. Using a dollar amount test for tuition benefits is no more sensible than testing a health care benefit (for a self-insured company) on a dollar value utilization basis. Under such a test, a health care plan could be found discriminatory simply because older, more experienced, and therefore more highly-paid employees tend to have more expensive cancer or heart care costs than do younger, less experienced, and therefore not highly-paid employees.

Second, using utilization and dollar cost comparisons rather than eligibility as a standard for non-discrimination means that some employees could be taxed as a result of the education choices of other employees' children. Many tuition reduction programs provide only a percentage of tuition and/or costs. Oberlin, as I mentioned, provides scholarship grants in an amount equal to 50% of Oberlin's current tuition. In choosing colleges for their children, therefore, employees must take into account their own ability to pay the remaining expense, with the result that children of lower-compensated employees may tend to select less expensive schools. Even if similar percentages of highly-compensated and lower-compensated employees actually utilize tuition reduction benefits, an average dollar cost comparison may result in a finding of discrimination.

Third, using utilization rather than eligibility as a standard for non-discrimination can mean that a tuition benefit that was non-discriminatory and therefore untaxed in one year could become discriminatory and taxable the following year with little or no predictability. Because of the educational choices of children of employees, actual employee utilization levels and the dollar value of benefits can change radically from year to year. The smaller the pool of employees being tested, the more marked will be the impact of slight changes in utilization rates or average dollar benefits. If, in one year, a few more children of less well paid employees than historical patterns indicate choose to attend less expensive colleges or choose not to attend college, a plan could suddenly and unexpectedly become discriminatory, forcing the prohibited group to pay tax on the benefit even though they had made no changes in participation or dollar levels themselves. For a prohibited group member who enrolled his child in a relatively expensive college the previous year (when the plan was non-discriminatory and therefore not taxable to him) this sudden change could result in such a serious tax impact to the employee as to force the child's transfer to a less expensive college. Because of these effects, the utilization and dollar value utilization criteria provide a very unstable discrimination test. This frustrates the ability of an institution to adopt a non-discriminatory program and completely destroys the ability of employees to plan for the education of their children.

The example attached to this testimony demonstrates, using Oberlin's employee profile, the impossibility of meeting the proposed non-discrimination test even if a tuition reduction program is available to 100% of all non-union employees. This example shows that only by discriminating against the prohibited group by denying the benefit to more than half its members could such a plan be made acceptable under President Reagan's proposal, and then only if it met the dollar amount criterion.

We suspect that these utilization criteria were proposed without thinking about whether or not they made any sense for tuition reduction benefits. As this testimony should make clear, they do not. Eligibility, not utilization, ought to be the test for tuition benefits. A tuition benefit should be available to all employees on a non-discriminatory basis; it simply cannot be used by all employees on such a basis.

The Reagan proposals also include a significant expansion of a "concentration test" to tuition benefits. Under the proposal, if the top 20 prohibited group participants utilize more than 25% of the total dollar benefits in any given year the tuition benefit would be considered discriminatory. For small colleges, no more than 20 prohibited group employees will be utilizing a tuition benefit in any year so the top 20 prohibited group participants will encompass all prohibited group participants. Since, as described earlier, there is a natural imbalance caused by the fact that older employees who have college-age children who can use the benefit will naturally tend to be disproportionately higher-paid than the whole employee pool, this test can, like the basic utilization tests, cause a finding of discrimination simply due to demographics. If there is a concentration of tuition benefits in the higher-paid group it is simply due to the fact that there is a concentration of college-age dependents of the higher-paid group.

While Oberlin and the other colleges and universities mentioned above which support Oberlin's position believe no utilization test is appropriate for determining nondiscrimination, if such a test must be used there are changes which could somewhat ameliorate some of the problems presented by a utilization test. First, apples should be compared with apples, not oranges. If relative rates of utilization of tuition grants between highly-paid employees and lower-paid employees are to be compared, only "similarly situated" employees in each group should be compared; that is, only employees with college-age children should be compared. Testing only employees with children aged 18 to 25 will eliminate the natural imbalance caused by the fact that older employees who have college-age children who can use the benefit will naturally tend to be disproportionately higher-paid than the whole employee pool. As lines 5 and 6 of the attached example ("Modified utilization test") show, again using Oberlin's employee profile, limiting the testing population to employees with college-age children makes a utilization test at least possible to meet.

Second, the uncertainty and instability of using a utilization test, particularly in small employee groups, can be somewhat reduced by raising the 125% requirement to a higher percentage. When changes in historical patterns of college attendance (and college cost) by just a few employee children or even a slight change from the historical pattern of number of employee children can make a non-discriminatory plan suddenly discriminatory, clearly some remedy is warranted. Since the present ruling position of the Internal Revenue Service can be read to support a 200% figure, we would suggest the use of such a figure for any relatively small (e.g. 200 or fewer) group of utilizers.

Third, also to protect participating employees from changes wrought by changed patterns of usage by fellow employees, any utilization test should not be used to tax a tuition benefit after an employee's child has entered college under a nondiscriminatory tuition reduction plan. If, because of change in utilization or dollar benefit patterns, a plan first became discriminatory during a student's sophomore year, for example, his or her parent should not be penalized with a perhaps unmeetable tax burden on what was expected to be a tax-free benefit. Without such relief, forced college transfers or interrupted college careers may become commonplace. This sort of unpredictable disruption is unfair and should be avoided.

Fourth, the concentration test should be eliminated for tuition benefits or should be greatly liberalized. Only if there is an undue concentration of benefits in the higher-paid group due to non-demographic factors should such concentration demonstrate discrimination. We submit that an eligibility discrimination test can more than adequately protect against such a problem.

In summary, eligibility, not utilization (either on an employee or a dollar benefits basis) should be the test for discrimination in tuition reduction plans. As a distant second best, to be avoided if at all possible, several modifications must be made if a utilization test is used, though even these modifications cannot eliminate the problems, particularly the unpredictability, raised by a utilization test. In addition, the proposed concentration test must be abandoned or liberalized. For the sake of fairness and simplicity, therefore, I urge you to adopt eligibility as the sole rule for testing tuition reduction plans for discrimination.

Reagan Tax Proposal -- Non-Discrimination Rule Application to Tuition Benefits

EXAMPLE

Eligibility Test (current law)

	1 Total full-time non-union employees w/more than 1 year service	2 Total eligible	3 % of Col. 1
1. Prohibited group (top 10% by comp. and others over $50,000)	42	42	100%
2. Non-prohibited group (all others)	371	371	100%

	Total full-time non-union employees w/more than 1 year service	Total utilizing tuition grants	% of Col. 1
Utilization test (Reagan proposal)			
3. Prohibited group	42	12*/	29%
4. Non-prohibited group	371	40	11%

	Total full-time non-union employees w/more than 1 year service and with at least one dependent aged 18-25	Total utilizing tuition grants	% of Col. 1
Modified utilization test (compare "similarly situated" employees)			
5. Prohibited group	17	12	71%
6. Non-prohibited group	52	40	77%

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*/ To meet proposed non-discrimination test, this number must be lowered to 5 (5/42 = 11.9% ≤ 125% of 40/371).

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KENNETH HANDY
Director of Financial Services

August 28, 1985

The Honorable Bob Packwood
Chairman
Committee on Finance
U. S. Senate
Room 219
Dirksen Building
Washington, D.C. 20510

Dear Mr. Chairman:

This is a statement for the record in connection with the hearings of the Committee on Finance on the retirement plan provisions in the President's Proposal for Tax Reform (the "Proposal"). This statement is made on behalf of The Permanente Medical Group, Inc. ("TPMG"). TPMG provides medical services in Northern California to members of Kaiser Foundation Health Plan, Inc. We believe that TPMG is the country's largest professional corporation, with over 1600 physician-shareholders. TPMG provides medical care to approximately 2,000,000 people in 14 counties in Northern California. Nationwide, the Kaiser Permanente Medical Care Program provides health care to about 4,800,000 people in 13 States and the District of Columbia. TPMG provides substantial retirement benefits to its employees.

SUMMARY

TPMG supports the retirement plan provisions of the Proposal that affect TPMG except in three respects. The exceptions are as follows: (1) TPMG supports the goals of the Proposal for 401(k) plans. However, TPMG believes that the Proposal does not work but that it can work well with some changes. (2) TPMG believes that the goals of eliminating special tax treatment for lump sum distributions are proper but cannot support the Proposal because it will operate regressively to the detriment of the lower paid.

TPMG would support this change if the lower paid were protected. (3) TPMG opposes the proposed change in the coverage rules because it would disrupt established rules that work. In addition, TPMG notes that present IRS regulations are almost the same as the Proposal, but the IRS has ignored these regulations in all respects.

BACKGROUND - TPMG'S RETIREMENT PROGRAM

TPMG has over 11,000 employees and provides substantial retirement programs for them. About 8,000 of TPMG's employees are covered by collectively bargained agreements, and their benefits are set by these agreements. The rest of TPMG's employees are provided with defined benefit and defined contribution plans, once they qualify under the applicable statutory and plan rules. Only one of TPMG's plans is integrated with Social Security. The only integrated plan maintained by TPMG is one collectively bargained plan where the union has refused TPMG's requests to eliminate integration.

TPMG's defined benefit plans for physicians and non-union non-physicians are almost the same, though not identical. These plans provide a benefit based on final average pay and have 10-year "cliff" vesting. Participants in both these plans generally can earn a pension of 50% of final average pay.

TPMG's defined contribution plans are more diverse. Non-union non-physicians have both a money purchase plan and a 401(k) plan; the physicians have only a 401(k) plan. Under the money purchase plan, participants set aside 2% of after-tax compensation and receive an employer contribution of 5% of compensation. Neither of the 401(k) plans provides for employer contributions; both operate on a salary reduction basis only. In this respect, the non-physicians receive more of a "real" employer contribution (that is, no salary reduction) than do the physicians.

TPMG SUPPORTS ALL BUT 3 OF THE PRESIDENT'S PROPOSALS WITH RESPECT TO RETIREMENT PLANS.

The President's Proposals concerning retirement programs are wide ranging and with many details. TPMG supports the following:

1. Uniform Distribution Rules.

2. Change in the basis recovery rule.

This support is conditioned on enactment of the effective date in the Proposal, which applies to benefits accrued after December 31, 1985. Any other effective date would be very harmful to employees who made voluntary contributions to plans in reliance on the existing rules.

3. Recapture tax on early distributions.

4. Changes in the 15% deduction rules for profit sharing and stock bonus plans.

5. Application of the 25% deduction limit to combinations of all defined contribution and defined benefit plans.

6. 10% excise tax on excess contributions to qualified plans.

7. Elimination of the "combined limit" on contributions and benefits by repeal of section 415(e).

TPMG strongly supports this change. It will substantially reduce unnecessary complexity of plan administration.

8. 10% excise tax on benefits from tax favored retirement vehicles in excess of 1.25 times the dollar limit on defined benefit plans.

This support is conditioned on indexing of the dollar limit, for this purpose, without interruption. In 1982, the Congress substantially reduced the defined benefit and defined contribution plan dollar limits but has also prevented indexing of these dollar limits for 4 years. Whatever the reason for this interruption (and we believe that it is wrong), it must not apply to the new proposed excise tax.

The present interruption in indexing affects contributions to and accruals under plans for people who are currently employed. They have an opportunity to adjust to lack of indexing and prepare for retirement in ways other than through qualified plans. But an interruption in indexing for the proposed excise tax would focus on retirees, who will not have this opportunity. If there is an interruption in the index for the proposed tax, people who receive larger amounts after retirement to adjust for increases in the cost of living could pay a special excise tax on amounts they need just to keep up with inflation. Interruption of this indexing, therefore, would in effect add a special and very unfair tax on retirees. Thus, if the proposed excise tax is adopted, the Committee should make a strong commitment in its Report on the bill that this index will not be interrupted.

We understand that this excise tax has been criticized as a "tax on success." We do not agree. It is a fair exchange for simplification effected through eliminating the 415(e) combined limit rules. In addition, the proposed tax is a fair method to recapture the benefits of tax deferral in cases of substantial deferrals.

9. Change in the rules treating employee contributions as annual additions under section 415.

10. Phase in of defined benefit plan limits over 10 years of plan participation rather than 10 years of service.

11. 10% excise tax on reversions from defined benefit plans.

12. Modification of rules for benefit forfeitures.

13. Modification of rules for plan loans to participants.

TPMG BELIEVES THAT THE REASON FOR ENDING SPECIAL TAX TREATMENT OF LUMP SUM DISTRIBUTIONS IS APPROPRIATE BUT TPMG CANNOT SUPPORT THE PROPOSED CHANGE BECAUSE IT IS REGRESSIVE. THEREFORE TPMG SUGGESTS CHANGES IN THE PROPOSAL.

The reason for the proposal to eliminate special tax treatment for lump sum distributions is to encourage retirement saving. TPMG strongly supports this encouragement. However, TPMG cannot support the Proposal to eliminate special lump sum treatment because it is regressive. Over 85% of TPMG rank-and-file plan participants take lump sums when they terminate employment (on or before retirement). The average distribution for hourly employees is about $17,000. The average distribution for non-physician salaried is about $50,000. Thus, the effect of elimination of the special tax treatment would fall most heavily on the lower paid. In addition, these people generally have the most difficulty understanding the complexities of a rollover IRA.

Because the lower paid will be most hurt by the Proposal, TPMG cannot support it. However, TPMG could support a proposal that limits the benefit of special lump sum treatment to rank-and-file participants. In this way, the lower paid would be protected.

TPMG SUPPORTS THE GOAL OF ELIMINATING DISCRIMINATION IN 401(k) PLANS BUT SUGGESTS CHANGES IN THE PROPOSAL SO IT WORKS PROPERLY.

We understand that a major goal of the President's 401(k) proposals is to eliminate undue discrimination that can occur under the present rules. Under the present rules, which test average contributions, employees can "leverage off the zeros;" for example, if the average deferral percentage for the top 1/3 must be 6%, with two employees who contribute nothing, a third employee can contribute 18% and the average for the three employees will be 6%. This disparity should be fixed.

1. TPMG supports the reduction in the average deferral percentage differential.

Present law allows a difference in the average deferral percentage (ADP) of 150% between high and lower paid. The Proposal suggests that this be lowered to 125%. We support this reduction.

2. TPMG supports an individual deferral percentage limit, but it should be applied to all participants, and should allow reasonable "catch-up".

Under the ADP rules of present law, plan participants in both the lower paid 2/3's and the high paid 1/3 groups can "average" their contributions. One important consequence of averaging is that employees can "catch up;"

they can make larger retirement plan contributions in years when they have the available resources to offset years when they are not able to set aside for retirement. Another consequence is that discriminatory "leveraging off the zeros" as described above can occur.

TPMG believes that both catch up and curbing of this discrimination can be achieved, in a very simple way. A new limit, an individual deferral percentage (IDP) should be enacted. This limit should apply to all plan participants, and it should be 2 times the ADP of the non-prohibited group.

Catch up is a necessary part of 401(k) plans because it allows employees to properly provide for their retirement. The rate of contribution to a 401(k) plan does not depend so much on the level of income of an employee as on his or her life circumstances. When an employee has a big mortgage, children in college, etc., he or she is less able to contribute, whether or not he or she is in the prohibited group. As these obligations go away (generally as the employee becomes older), an employee will contribute more for retirement--will "catch up." The need for catch up is recognized in the President's Proposal (p. 365).

Not only is catch up necessary but so is a curbing of the discrimination now available. We believe that an IDP that is 2 times the ADP of the non-prohibited group will properly do this. The Proposal would add an IDP, but one that invites evasion and thus will not work. The Proposal would add an IDP only for the prohibited group and would make the IDP 1.25 times the non-prohibited group's ADP. The Proposal puts no IDP limit on members of the non-prohibited group. But if the IDP does not apply to all participants in the plan, there will be a substantial incentive to shift people from the prohibited group to the non-prohibited group. (The easiest way to do this is with nonqualified salary deferrals.) Therefore, the Proposal invites evasion and will not work.

In addition, if catch up is fair for some, it is fair for all. As described above, people set aside money in a 401(k) plan because of their life circumstances, and employees at all income levels face the same issues. Therefore, whatever catch up is available for the non-prohibited group should be available for everyone. We believe that a

"2 times" IDP limit*/ will provide reasonable catch up, curb the abuses, and thus establish proper nondiscrimination rules.

3. With proper nondiscrimination rules, the $8,000 cap is not needed; in fact it will operate perversely.

The major goal of the Proposal is to reduce the "currently excessive disparity permitted between the elective contributions of the prohibited group members and the elective contributions of the other employees." (Proposal, p. 370.) This is achieved with TPMG's IDP proposal. With TPMG's proposal on the IDP, the $8,000 cap (or any cap) is not needed to achieve this goal.

Not only is a cap not needed, but a cap will act perversely. If a cap on elective deferrals is enacted, to provide maximum contributions under a defined contribution plan, employers will establish plans with fixed formula contributions. This will, in effect, require set asides from amounts now paid as compensation to employees who elect not to defer. Maximum set aside is what the majority of employees want. But this will force employees who do not want to contribute to do so. This is perverse; instead of allowing employees to take current income and pay the tax, a cap on elective deferrals will create a situation where employees will have to defer income in a plan.

In addition, a cap on elective deferrals will encourage professional incorporation. Many professional partnerships and corporations allow individual corporate shareholders. (TPMG does not.) TEFRA went a long way to eliminate these individual corporations by eliminating the disparity in benefits between incorporated and unincorporated individuals. But incorporation gives flexibility in plan contributions. With individual incorporation, the professional can effectively choose a lower level of contributions. Since a cap on elective deferrals will reduce flexibility, it will encourage professionals who do not want to contribute to plans to incorporate, individually. This effect of a cap--more individually incorporated professionals--clearly is wrong.*/

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*/ As a technical matter, this should be 2 times the prior year's ADP; otherwise "simultaneous equations" will be required.

4. TPMG supports a narrower definition of the prohibited group, but the Proposal does not achieve this result.

The Proposal suggests that the prohibited group be all those who earn more than $50,000 a year; are the top 10% earners; own at least 1% of the employer; or are family members of these employees. It also would apply a 3-year lookback for testing.

The goal of the Proposal is to narrow the prohibited group, limiting the ability to prove larger deferrals for the higher paid. But this proposal would broaden the prohibited group, putting over 2/3's of TPMG's non-union employees in the prohibited group.

TPMG suggests a simple change to the Proposal to solve this problem. The prohibited group should be the smaller number of those employees who earn over $50,000 or earn the top 10% of compensation.

In addition, two parts of the Proposal cause unnecessary burdens: the 3-year lookback and the family attribution test. The lookback may have been suggested to avoid movement between the prohibited and non-prohibited groups, but it is complex and difficult to administer. Our suggestion above for an IDP that applies to all participants solves the problem, fairly and simply. In connection with family members, TPMG has a number of physicians married to each other; if their compensation must be aggregated in determining the top 10% of pay, these family units would unfairly be treated as being in the prohibited group even if, singly, they are nowhere near the top 10%.

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*/ Section 269A will not prevent this. This section is directed at taxpayers who report less income; here incorporation would be used to report more income.

5. The Proposal would encourage employers to limit their "matching" contributions; this would be to the severe detriment of the rank-and-file and should not be enacted.

The Proposal would impose a 110% ADP test on plans which provide for matching contributions where the employer match is more than 100% of the employee mandatory contribution. The 125% test would be used for plans where the employer match is 100% or less. The obvious objective is to encourage employers to give no more than a 100% match. TPMG's plan for non-physician salaried employees provides a 250% match. (There is no match for physicians.) The plan works well, with about a 90% participation rate. If the proposal is enacted, TPMG would most likely reduce the amount of contributions provided for rank-and-file salaried employees. There is no reason for the Congress to encourage TPMG to give its rank-and-file employees lower benefits. In fact, the Proposal gives no rationale for this reduction in benefits. Therefore, this proposal should not be enacted.

TPMG OPPOSES THE SUGGESTED CHANGES TO THE COVERAGE RULES.

The Proposal would eliminate all of the current rules requiring nondiscrimination in coverage and replace them with a single numerical test. We oppose this change.

The current coverage rules provide both an objective and a facts and circumstances test. The objective test requires that a stated percentage of "all" employees be covered by a plan. The facts and circumstances test can be met if the IRS determines that a plan is nondiscriminatory under the particular facts for the employer.

For some time, the facts and circumstances test (but not the objective test) has been criticized. The criticism has mainly been that the facts and circumstances test is subjective and is not uniformly applied by the IRS.

In 1980, the IRS issued new, post-ERISA regulations to restate the facts and circumstances test. Reg. 1.410(b)-1(d)(2). These regulations provide that this test is met if there is no more than a reasonable difference between the percentage of prohibited group employees covered and the percentage of other employees covered. This is almost the same as the test that is now put forth in the Proposal. The only differences are the use of an objective definition of the prohibited group (and this part of the Proposal needs to be changed, as described above) and the rule that more than a 25% differential in percentages of coverage is not a reasonable difference.

Under these circumstances, one would expect that the IRS would have tried out its regulation, have determined that it operates correctly, and would only be asking for technical changes to make it work better. That is not the case. In fact, as far as we can tell, the IRS has never applied this regulation. It does not apply it in the determination letter process; it has not applied it in the applicable rulings that were issued after the regulation was published. Instead, the pre-regulation tests are used.

Therefore, the Administration is asking the Congress to enact a discrimination test that the IRS could now be using but does not use. There has been no explanation of why it is not used, and we can only speculate on the reasons. The most likely reason is that the IRS believes that it will not work.

In fact, this test will not work. The economic settings in which retirement plans have developed in the last 40 plus years are many and complex. There is no reason to believe that any one, rigid nondiscrimination test can properly deal with all these complex multiemployer and parent/subsidiary/geographic settings (and there is no reason to believe that any one such test is needed as a policy matter).

Therefore, several matters need attention. First, the 70% objective coverage test should be retained. The 70% test is a fair way to achieve three goals: (1) ensure that the bulk of employees are covered by a plan, (2) provide leeway for the economic differences that are inevitable in our very complex economy, and (3) provide a test easily administered by the IRS.

Differences in benefit packages occur because employers compete in different labor markets; the tax laws must (and do) recognize this reality. For example, the Kaiser Permanente Medical Care Program has over two dozen pension plans, with special plans tailored to meet special needs. For the most part, the multiplicity of plans exists because of collective bargaining agreements, and the vast bulk of other employees are in two other pension plans (a defined benefit and a defined contribution plan). But special cases exist, e.g., non-union hourly who have plans that conform to union plans. The 70% test provides a way for all of these plans to qualify and thus allows recognition of different economic circumstances without putting the IRS to a difficult administrative task.

Second, while the facts and circumstances test is uncertain, this does not mean that the Proposal is right. Indeed, the IRS track record with respect to the existing regulation strongly suggests that the Proposal is not right. If the Committee wishes to pursue this test, however, legislation is not needed. All that is needed is for the Committee to direct the IRS to start to make such modifications in the current regulation as are needed and start to apply it. The results of that action will determine if legislation is necessary.

CONCLUSION

TPMG believes that, for the most part, the President's Proposal on retirement plans is good policy and should be enacted. However, as described above, some changes should be made for the Proposal to operate properly, and in one case (with respect to coverage) the Proposal is wrong and should not be enacted.

Respectfully submitted,

THE PERMANENTE MEDICAL GROUP, INC.

By Kenneth Handy
Kenneth P. Handy
Director of Financial Services

Statement by

David L. Ream, CIC,CPIA
Chairman
Government Affairs Committee

of the National Association of

PROFESSIONAL INSURANCE AGENTS

concerning

THE IMPACT OF TAX REFORM ON EMPLOYEE BENEFIT PROGRAMS

Submitted to the

COMMITTEE ON FINANCE

U.S. SENATE

July 19, 1985

The following statement is submitted by the National Association of Professional Insurance Agents (PIA) for inclusion in the hearing record of the Committee on Finance for the July 19, 1985 hearing on the impact of the President's tax reform proposal on employee benefits.

PIA is a national trade association representing 40,000 independent property and casualty insurance agents in all 50 States, the District of Columbia, Puerto Rico and the U.S. Virgin Islands.

The typical PIA member is a small businessperson with three or four employees. They typically represent seven insurance companies which enables them to provide maximum insurance services and protection tailored to meet their clients' needs. The PIA member is often a community-minded leader active in local service and volunteer organizations.

On May 28, 1985, President Reagan released his Administration's plan for a comprehensive revision and "reform" of the Internal Revenue Code of 1954, as amended. This plan proposes a number of very controversial changes in the current tax treatment of employee benefits. If these changes were to become law, employees would be required to pay income taxes on all or a part of their employer's cost of providing various employee benefits. Such benefits are generally tax preferred or tax exempt under current law.

The plan has generated considerable grass roots activity from a multitude of interests that would be adversely affected. A broad based coalition of insurance, business, labor, and service organizations, formed to oppose the original Treasury Department employee benefits taxation recommendations, is actively opposing the President's employee benefits tax proposals. PIA is a member of that coalition.

Congress has long supported, as a matter of public policy, the use of tax incentives to encourage the development and implementation of private employer-provided benefit programs to ensure economic security and adequate health care for employees and their dependents. Group life insurance and pensions have received preferred tax treatment since the inception of the federal income tax, and for the last three decades group health insurance has been tax-free. Pension plans have also been encouraged by more recent legislative activity

The cumulative results of this effort by Congress to promote private sector employee benefits has become one of our nation's great legislative and social policy success stories. The current use of tax incentives to support employee benefits such as pensions, health insurance, life insurance, dental insurance, and disability coverage has resulted in a cost effective delivery system that provides essential financial security for millions of employees and their dependents. Eighty-two percent of workers are now covered by pensions for retirement and related savings plans. Neary 80 percent receive group health insurance coverage. Americans have come to expect and believe that adequate tax preferred employee benefits will be provided by their employers. These benefits are simply taken for granted as a requisite condition of employment.

By encouraging the growth of private sector benefit plans, the government also supplements and strengthens the effectiveness of existing federal benefit programs such as Social Security, Medicare and workers' compensation.

Current law exempts from taxation as employee income employer-provided health insurance, group life insurance, death benefits, group legal insurance, dependent care, scholarships and fellowships, and awards for exceptional performance.

The Reagan Administration proposes to curtail or eliminate the tax preferences for a number of important employee benefits. This appears to be an integral part of their tax reform package which, if it is to be successful, must expand the taxable revenue base so that tax rates for individuals can be reduced while maintaining revenue neutrality. Viewed from this perspective, the tax reformers at the Treasury Department see the dollars spent on employee benefits as a potential revenue plum, ripe for the picking.

Although employee benefits, on average, constitute one-third of total employee compensation, most are either taxable as ordinary income at some point or are required by government. In reality, only around 4.5 percent of total employee benefits are tax exempt. PIA would, therefore, like to suggest that the loss to the Treasury caused by tax-free employee benefits may not, in reality, be as much of a problem as the Administration contends.

The National Association of Professional Insurance Agents strongly opposes any taxation of employer-provided employee benefits. The preservation of the present tax treatment of employee benefits is essential for assuring the continuation and expansion of the benefits currently provided to workers and their dependents. These benefits are necessary for the health, economic security, and well-being of the American people.

Last year, the Treasury Department's tax reform recommendations (Treasury I) proposed a so-called "cap" on the tax exempt treatment of employee group health insurance. Employer premium payments in excess of $70 per month for individuals and $175 per month for family coverage would become taxable income to the employee.

The cap approach would cause serious consequences for certain groups of employees. Older workers generally have a greater need for health care services. This cap would tend to induce younger healthy workers to either drop health coverage or limit it to the amount that could be obtained within the cap to avoid a tax increase. Older workers, the additional taxes notwithstanding, would continue to demand full coverage for obvious reasons. This result would be a classic case of what the insurance industry calls "adverse selection." The aggregate group premium base would be reduced by the response of younger workers, leaving older employees and their employers to face much higher health coverage costs. Workers engaged in hazardous occupations would also be placed in an adverse selection situation by the cap.

In certain areas of the country, such as New York and California, health care costs are much higher than the national average. Employees in such high cost areas must, as a practical matter, exceed the cap and incur a tax increase simply to obtain minimal adequate coverage.

There is reason to believe, based on Treasury Department statistics, that the cap would impose an income tax increase on about 50% of employees receiving employee health care benefits. This additional tax burden would be concentrated among those categories of workers most in need of health care coverage and fall heavily on those in lower income occupations. The average age of PIA members is 47 and the cap would, therefore, burden them with the problems that it would cause for all older employees.

PIA is totally opposed to the Treasury I cap concept.

The vigorous political protest generated by the cap may have persuaded the Administration to offer an alternative method of taxing health care benefits because their May 28th tax package proposed a so-called "floor." The floor would tax, as employee ordinary income, the first $10 of monthly health care benefit costs for individuals and the first $25 for family coverage. It would have less adverse impact on those employees who are in poor health, older, engaged in hazardous occupations and reside in high health care cost areas, but it also creates other serious problems of its own.

A floor would impose an additional income tax burden on all working individuals and families that receive employer-provided health care benefits. Its harshest impact would fall on low income families that could least afford this new tax burden as a percentage of disposable income. It lacks any incentive for employers to efficiently provide and employees to efficiently utilize health care benefits options, a goal some contend a cap would encourage. The floor's only benefit to anyone would be to the tax collectors as a revenue raiser. It would be a regressive tax increase on millions of American workers.

PIA is totally opposed to the Administration's tax floor on employee health care benefits. We believe that there should be no taxes imposed because essential health benefits to the employed public would be compromised and this would constitute an unwise and harmful change in public policy. It is without merit.

Treasury I recommended the repeal of the popular Section 401(k) plans that allow employees to contribute either 25% of their income or $30,000 annually, whichever is less, to an employer-sponsored tax-free profit sharing/savings program to provide for their retirement.

The Administration's plan compromised on the Treasury's approach by limiting the Section 401(k) contribution to $8,000 minus Individual Retirement Account contributions. Employees would not be permitted to utilize their accumulated Section 401(k) contributions on a "hardship" basis to meet an emergency need for funds. A difficult to comply with "actual deferral percentage" test would replace the existing participation test.

The result of these proposed Section 401(k) amendments will be reduced participation because employees would lose the ability to make hardship withdrawals without incurring a penalty. Employers will face new administrative costs and difficult to comply with regulatory burdens that will make the offering or continuation of Section 401(k) plans a much less attractive proposition when compared to the current program.

PIA believes that the Administration's Section 401(k) amendments would be counter-productive and discourage employer/employee participation in this worthwhile retirement savings program. This is certainly not the way to induce people to provide for their retirement years. These amendment should not be considered or approved by the Committee.

Under the Administration's proposed treatment of retirement programs, other than Section 401(k) plans, early withdrawals would be subject to a new 20% federal excise tax. This is a rather stiff tax bite that is excessive. There is also a hardship provision that would reduce the 20% penalty to only 10% if the distribution is used for college expenses, the purchase of a residence or to cushion unemployment. Again, this heavy-handed approach would discourage many employees from participating in these retirement programs and would reduce a retirement plan's functional utility over the years. PIA beleives that this approach would be counterproductive and a step backward which the Committee should not take.

Current law excludes from income taxation $5,000 in employer-provided death benefits. The Administration would repeal this provision which is designed to help a worker's dependents provide for a proper funeral and meet related expenses. This proposed amendment lacks any redeeming merit.

The sweeping changes in the tax treatment of employee benefits recommended by the Administration ignore important social goals carefully charted by the Congress over the years. The only real purpose of said changes is to raise revenue, but they would also undermine an important aspect of the financial security provided by the private sector to millions of citizens.

PIA recognizes the need for tax reform and to reduce the federal budget deficit. However, it is important that Congress not lose sight of the tremendous positive impact that employee benefits have on our nation's social and economic well-being. Providing the tax incentives that make benefit plans attractive to employers and employees helps further the laudable public policy goal of increasing the private sector's self reliance and of decreasing dependence by our citizens on costly federal entitlement programs.

These proposed new taxes would threaten the security and well-being of employees and their dependents. If such taxes are enacted, employers and employees alike would immediately re-evaluate the status of their benefits package. Employers would reduce the spectrum of benefits available to workers to avoid added administrative expenses and tax withholding burdens. Employees are likely to decline or opt out of portions of the protections available to them to avoid paying the higher taxes that would be due if they were to participate. This would leave these hard working citizens and their families dangerously vulnerable to financial disaster should serious illness, injury or other calamity strike a household lacking adequate coverage.

The advent of tax preferred employee benefits has been a great assistance to smaller businesses such as the insurance agencies run by PIA members, because it allows them to match the benefits offered by larger employers in attracting and retaining quality employees. Taxing those benefits could jeopardize their ability to compete in this vital area.

Many independent insurance agents would face a double-barreled problem, if employee benefits were to be taxed, because they wear two hats. They are both an employer as owner of their agency, and an employee of the agency as chief executive officer. They would be hit with all of the costs and administrative disincentives that would be imposed on the corporate entity, and also have to face the added tax burden as employees. This situation would be a double incentive for them to reduce the scope of employee benefits currently offered by their insurance agency.

The proposed tax on private sector employee benefit plans would be a major step backward. Many employers and employees would be discouraged from participating in private plans and they would eventually turn for protection to the federal government which would be forced to step in and fill the void with costly new entitlement programs. Consequently, even more of our citizens would become reliant upon the federal government for basic security needs. This would impose additional future budgetary problems on the Congress and increase the real tax burden on the American people. Within this context, PIA doubts that anyone could seriously or honestly argue that the federal government could somehow provide these health and life insurance, and retirement benefits at a lower aggregate cost to society than the current tax preferred private sector employee benefit programs. If the experience with existing federal entitlements is any indication, such new federal welfare programs would cost the Treasury far more than is currently lost in revenue under the existing tax preferred employee benefits structure.

The present employee benefits situation works very well, is cost efficient, and benefits millions of Americans. PIA would like to strongly recommend to the Committee that, "if it ain't broke," which it isn't, "don't try to fix it." It should be Congress' goal to continue moving forward in this area, not backward. You are entrusted with preserving the progress that has been made in this area.

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STATEMENT OF
WALTER HOLAN
President
Profit Sharing Council of America
on
The Impact of the Tax Reform Proposals
on Profit Sharing Plans

July 19, 1985

Senate Committee on Finance
Employee Benefits Hearing

The Profit Sharing Council of America is a non-profit association of approximately 1300 American employers who maintain profit sharing plans. Deferred profit sharing plans will be the sole or primary private source of retirement benefits for a very large segment of today's working men and women. There are approximately 360,000 deferred profit sharing plans in the United States today covering over 20 million employees. The legislation you are considering will be a fundamental determinant of how much of their accounts' accumulation will remain after taxation to actually provide retirement security, and how much flexibility will be allowed for each person to exercise individual judgment in the use of his or her profit sharing distribution.

Profit sharing is an incentive system and productivity booster whose design, application and approach differs according to the needs and problems of individual firms. When employees become profit conscious, friction eases, production spurts, costs drop and profits rise. Profit sharing promotes and sustains morale, interest, allegiance and loyalty on the part of employees. When management intelligently shares profits, the company prospers, the stockholders prosper, the employees prosper and the nation prospers. Many of the tax reform proposals do not seem to take these incentive factors into account, but concentrate only on the retirement aspects of profit sharing.

In 1939, the Vandenberg-Henning Subcommittee of the Senate Finance Committee conducted an intensive study of profit sharing plans and concluded: "We believe it (profit sharing) to be essential to the ultimate maintenance of the capitalistic system." Partly influenced by these favorable findings, Congress passed legislation providing tax advantages for qualified, non-discriminatory deferred profit sharing plans. Over the years, legislation affecting profit sharing has had two primary objectives: first, to see that participant's rights and accounts are protected, and, second to prevent discrimination in plans.

The new tax proposals, however, represent a sharp departure from Congressional practice, are an intensive attack on profit sharing plans, and reflect a lack of understanding as to how such plans operate. We strongly urge the Committee to reject all those proposals which have an adverse affect on profit sharing.

Profit sharing is that rare and happy creation that offers rich benefits to both employer and employee. It is an incentive for increasing productivity and decreasing costs; it provides retirement security; it delivers benefits in the event of disability, death or employment termination prior to retirement; it helps attract and retain quality personnel; most importantly, it shares the rewards of the free enterprise system broadly throughout the organization.

The tax proposals ignore the fundamental differences that separate the two principal retirement plans. With profit sharers, if there is no profit, there is no profit sharing ccontribution. Profit sharing amounts are allocated irrevocably to vested participants' accounts where the assets are accumulated at market risk until they are ultimately delivered to the participant (or beneficiary) usually at retirement. This is in stark contrast to a defined benefit pension plan which promises a set periodic payment after retirement, regardless of the profitability of the employer. Investment losses or gains affect only the employer's funding.

Despite these differences, the proposals insist on treating all retirement plans alike on the basis that these plans are related in "concept and purpose." Profit sharing (and Employee Stock Ownership Plans) are the only employee benefits that can realistically motivate employees to greater productivity by offering a share of the fruits of progress. Defined benefit pension plans have no incentive value, for they are only a conditional promise to deliver a future benefit. Thus, the concept and purpose differs markedly.

Our 1983 survey of profit sharing plans showed that 20% of members responding made an employer contribution of an amount less than 3.5% of pay. Of those companies, almost two-thirds had fewer than 300 employees. Annual profits of smaller companies tend to fluctuate more than those of larger companies. Yet, the proposals on employer deductibility would eliminate the carryover provisions which permit companies in good years to put additional amounts into participant's accounts to balance off the years in which no contributions or smaller contributions were made. Statutory prohibition of carryover provisions would lend a "heads you win, tails I lose" flavor to profit sharing plans at such firms. Most important of all, it would reduce the employee's retirement benefit, surely a goal no one intends.

The annual limit on the amount which can be contributed to each individual's account would have another extremely adverse affect. A number of profit sharing plans allocate on the basis of service as well as compensation. This feature rewards employment longevity and accelerates growth in the accounts of individuals approaching retirement. This is particularly important in bringing low-paid individuals to an adequate level of retirement security. But the Treasury proposals would severely inhibit this practice, which has been a principal element of some of the nation's oldest and most successful profit sharing plans.

The deductibility and individual limit proposals will insure that if a company is successful in motivating its employees to greater profits, employees will not fully share in this profitabiliy.

The new rules on withdrawals from profit sharing plans would severely limit savings in profit sharing plans, particularly by younger employees. Several years ago, when Individual Retirement Accounts became available for private plan participants, a number of our member firms with voluntary non-deductible savings plans suggested their employees convert these savings to deductible IRA contributions within the plan. But when young employees discovered the withdrawal restrictions and penalties before age 59½, they weren't interested in converting. They stayed with their old non-deductible savings plan because of the availability of these funds in an emergency. New proposals would impose smilar restrictions or penalties on in-service withdrawals from profit sharing plans. And we predict young people will again simply not save money that is not reasonably accessible. We feel it is extremely important that young people save in their profit sharing plans because the compounding effect of these extra funds over 20 or 30 years provides the boost that insures a secure retirement lifestyle. The encouragement of thrift, in our opinion, is much more important than the correction of any minor abuses which may occur in this area.

The abolition of 10-year averaging and capital gain taxation for lump sum distribution and unrealized appreciation exclusion on distributed employer stock ignores the fact that profit sharing participants' accounts are "at risk" and have typically been built up over 20, 30 or 40 years of ups and downs. Lump sum distributions are taken primarily by low- and middle-income individuals and not by higher paid executives. Normally, executives will roll over their distributions for tax and estate planning reasons.

Employees in the lower or middle class often take lump sum payments to pay off the mortgage on a home, to move to a more favorable climate and purchase a retirement home, to have funds for costly medical care, and to make investments with remaining money to maintain the level of his or her economic security in retirement.

The proposal does allow the participant to rollover his or her distribution into an Individual Retirement Account. In fact, it virtually forces the individual to do so. Those who object to allowing participants to receive a lump sum seem to have no confidence in the ability of the American worker to handle his or her own funds in retirement. In the Council's many years of experience, the great majority of participants in profit sharing plans want and take lump sum distributions and we have never heard of one instance in which a lump sum given at retirement has been squandered by the participant. If such events were to occur, I am sure that Council members would see to it that profit sharing payments were made on an installment basis since they, too, are concerned with the needs of their retiring employees.

If the tax proposals become law, an employee nearing retirement with a profit sharing account built with sweat and diligence over a quarter-century or more will learn that an unappetizing choice must be made at the time of the account's lump sum distribution: pay high taxes and maybe penalties, or roll it over into an Individual Retirement Account.

While a rollover IRA can be a highly beneficial device when it is freely selected by an individual who has considered all alternatives, it is not a miracle solution to every retiree's financial management requirements, particularly if that retiree is younger than 59½. Or if the retiree and the IRA are joined in a shotgun wedding.

Those individuals who receive employer stock at retirement are particularly harmed by these proposals. First, should they decide not to rollover, they are taxed at the market value of the stock, even though they have not sold the stock. They have borne the same risk as any other investor, yet they are taxed on a discrimination basis. The individual investor only pays tax on unrealized appreciation when the stock is sold. Second, to pay the tax, the individual must sell all or a portion of the stock. This decision may be forced when the price of the stock is low. Many plan participants who now receive employer stock anticipate keeping such stock at retirement, living on the dividends, and selling the stock at a time they choose. If they are forced to rollover their stock, not only do they lose this retirement flexibility, they will face additional charges in the rollovers. The institution that receives the rollover will not do so as a public service. It will be a bank or stockbroker or other profit-making enterprise which will charge trustee fees, or investment management fees, or brokerage fees.

The new non-discrimination rules for tax favored retirement plans have been designed because the old rules created situations where, according to the proposals, discrimination was resolved on the "basis of the facts and circumstances in each case." The new tax proposals supposedly create non-discrimination tests which provide greater certainty. In fact it does just the opposite. They are complicated and no one seems to understand them fully. Parenthetically, it seems ridiculous under one test to call an individual making $20,001 "highly compensated."

Instead of the present non-discrimination rules under which coverage must be given to a "fair cross-section" of employees, a new rule has been substituted. Under this rule the percentage of participation by the top 10% of employees cannot exceed 125% of the participation of the bottom 90%. A controlled group of corporations is treated as one employer.

In some situations, if a disproportionately large percentage of the higher paid employees work for a particular company, that company's plan may not qualify even though all of its employees participate in the plan. Companies set up their plans to be competitive with similar companies in the same industry. Thus, plans are not necessarily uniform among different companies in the same controlled group. Certainly where a profit sharing plan covers all or nearly all of the employees in a specific company or in a particular industry it should qualify as non-discriminatory.

We feel the current eligibility rules have served well in seeing that all classes of employees receive benefits in profit sharing plans. They have provided more certainty in their application than the proposed rules would provide. If there is anything to be said against the current rules, it is the application of the "top heavy" rules which remain in existence under these proposals, and they are extremely burdensome to small businesses.

In recent years, many companies, including numerous profit sharing companies, have adopted 401(k) plans. They have spent literally millions of dollars setting up and promoting such plans to their employees and the employees have responded enthusiastically. The new proposals would impose new and complex non-discrimination rules, and rules affecting both deferral percentages and matching contributions. These proposals would reduce the amount of employee savings and create an administrative nightmare to see that the rules are followed.

In conclusion, the tax proposals affecting profit sharing are not fair. They will inhibit economic growth rather than promote it, and its authors have publicly admitted the goal of simplicity has been abandoned. If you wish to promote and encourage profit sharing as an important weapon in the "maintenance of our capitalistic system" we urge you to drop these ill-conceived proposals.

STATEMENT OF SAMARITAN HEALTH SERVICE, PHOENIX, ARIZONA
HOWARD ROHAN, VICE PRESIDENT, HUMAN RESOURCES

EFFECT OF THE PRESIDENT'S TAX PROPOSALS ON EMPLOYEE BENEFITS IN 501(c)(3) ORGANIZATIONS

Samaritan Health Service is the ninth largest secular non-profit hospital system in the nation, operating both acute care hospital beds and a full complement of outpatient and other health-related services. Staffing these facilities requires approximately 7,800 salaried employees.

Samaritan takes seriously its responsibilities to employees, particularly those relating to retirement planning. In this regard, it maintains a 401(k) plan with an employer match. Employees have responded enthusiastically to this effort to "help them help themselves" as evidenced by the fact that although relatively new, the plan already enjoys a 60 percent participation rate across all salary levels, and participation is growing. Clearly, Samaritan's employees in all income and age brackets accept personal responsibility for their retirement years and are willing to make present sacrifices to achieve this long-term goal.

Incredibly, the Administration's proposals seek to throttle this self-reliance; as the Committee knows, the President's Proposals single out employees of tax-exempt organizations and denies them continued access to 401(k) plans simply because their employer is legitimately organized under 501(c) of the Internal Revenue Code. This result violates the professed intent of the proposals, rests on demonstrably false assumptions, and handicaps non-profit employers in their efforts to attract and retain qualified employees.

The text of the President's Proposals and the related media blitz are careful to stress the alleged social policy and philosophical underpinnings of the proposed tax reforms. Among these, concepts of fairness, simplicity, and encouraging personal savings are preeminent and often repeated. It is impossible to reconcile these concepts with attempts to impose unreasonable limitations and complex new rules on 401(k) plans. In particular, the proposal to flatly eliminate access to 401(k) plans for employees of non-profit organizations is anything but "fair." Is it possible that Treasury's drafters do not know that many 501(c)(3) organizations, such as hospitals, compete with for-profit entities in the same industry?

Treasury's apparent response to this question is that parity between the for-profit and non-profit sectors is maintained because 501(c)(3) organizations have access to 403(b) and 457 plans. Unfortunately, this assumption simply is not true. Under 401(k) plans, employees may enroll at any time and vary the level of their contribution during the year in response to emergency cash needs. In stark contrast, under 403(b) plans, employees must determine their level of deduction by January 1. That level may not be raised or lowered during the year; their only recourse in the event hardships arise is to withdraw totally from the plan until no earlier than the following January 1.

Further, under 403(b) plans, investment mediums uniformly impose a cash penalty on early withdrawals which would be in addition to Treasury's proposed excise tax. Thus, unlike 401(k)s, early withdrawals from 403(b) plans will be subject to double penalties, further eroding any arguable parity. Finally, under 403(b) plans, investment alternatives are strictly limited to annuities and custodial accounts with far less potential for growth than is available under 401(k) plans. For these and other reasons, 403(b) plans are far more restrictive and have never enjoyed popular employee support, as evidenced by relative participation rates in the two types of plans. One survey of the non-profit hospital industry revealed participation rates of 10-15 percent in 403(b) plans as opposed to the 60-80 percent participation found in 401(k)s. This higher 401(k) participation rate clearly demonstrates the broad cross-section of participation in terms of age, sex and income. It is also a fact that 401(k) plans have been the most popular of any voluntary benefit plans designed.

Any knowledgeable analysis of the so-called 457 plans leads to the same conclusion: they are no substitute for 401(k)s. In the first place, 457s must be unfunded, thus risking evaporation of employee interests in the event of employer bankruptcy or adverse actions by creditors. In a related vein, ERISA requires that any broad-based plan must be funded; consequently, 457s would appear to be unavailable if an employer seeks to offer a retirement plan available to all employees. Finally, under 457 plans employers are not permitted to match employee savings.

This single fact irrevocably precludes what should be a social goal of paramount importance: organizations and employees working together to provide for retirement years. On a less philosophical but still important pragmatic level, the absence of an employer match coupled with the risks posed by the statutory lack of funding means few employees will find 457 plans an attractive option. This fact brings me to my final but crucial point.

It should be patent that 403(b) and 457 plans on their face are in no way equivalent to the 401(k) plans which would continue to be available to employees of for-profit organizations. Adding to this disparity is the fact that for-profit organizations already have access to attractive options that are simply unavailable to non-profit organizations. Stock options are but a single case-in-point.

In this context, we urge Congress to remember that for-profit and non-profit organizations often labor in the same field and compete for the same limited pool of employee talent. The health care industry is an obvious example of this phenomenon. Moreover, it is a mistake to assume that competition for employee talent is restricted to organizations in the same general industry. Non-profits must compete across industry lines not only for certain disciplines such as line management, human resources, financial analysts, and the like, but also for secretarial, clerical, and service and maintenance staff. Clearly and tragically, any change which would compromise the benefits non-profits may offer employees strikes a crippling blow at their ability to attract and retain talent relative to for-profit organizations. And, of course, it goes without saying that talented staff is essential to any organization's survival. In short, it is our sincere belief that use of these sensible, flexible, and inexpensive plans should be encouraged -- rather than constrained -- for the broadest possible number of American workers. In the short-run, they foster principles of thrift and closer cooperative efforts between employers and employees to provide for retirement years. In the long-run, they lessen the demand for extensive and expensive governmental retirement income programs which must be financed 100 percent by federal dollars.

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Statement of Sears, Roebuck and Co.

to

Committee on Finance
United States Senate

on

Employee Benefit Tax Proposals

August 2, 1985

Sears, Roebuck and Co. is filing this statement to discuss the proposals to revise the treatment of retirement savings, and the effect these proposals would have on millions of Americans, including the nearly 300,000 employee participants in the Sears Profit Sharing Fund.

The Pesident's tax proposals would make major changes in the tax treatment for employee participants in qualified Profit Sharing Plans. These changes would have an adverse effect on all Sears employees participating in Sears Profit Sharing Fund.

The Fund was created on July 1, 1916, 69 years ago, 20 years before the adoption of Social Security. The main purpose of the Plan from its very beginning was to provide for the financial security of the employees upon their retirement from the Company and to enable them to meet other financial needs as they arise.

This was accomplished by providing the employees the opportunity to share in the profits, the opportunity to acquire a proprietary interest in the Company, and the opportunity for employee savings.

In 1983, the Plan was amended to add a payroll-based ESOP feature. In 1984, the Plan was further amended to add a Section 401(k) cash or deferred option.

Sears employees are eligible to participate in the Profit Sharing Fund after one year of service. The Plan provides for full and immediate vesting for all participants.

As in all defined contribution plans, every participant has his own account in the Fund. The employee's own deposits and his share of the Company contributions are credited to this account. The account is invested in shares of Sears stock and other investments. The income from these investments is credited to the employee's account and reinvested for him. The employee's account is also credited with market appreciation or charged with any depreciation on his other investments.

Employees may contribute 3% or 5% of their compensation as basic pre-tax deposits. After contributing 5% as basic pre-tax deposits, the employee may elect an additional 5% as pre-tax deposits, and/or also contribute up to 10% of the remaining pay as after-tax deposits. The pre-tax deposits, of course, are not taxed to the employee for Federal income tax purposes until withdrawn from the Fund. The after-tax deposits are subject to Federal income tax when made.

The Company contributes 6% of its pre-tax net income. The Company contribution is allocated to employees on the basis of their basic pre-tax deposits.

In complying with one of the original purposes of the Fund--to allow the employees to acquire a proprietary interest in the Company--the Fund has invested a substantial portion of its assets in Sears stock which is allocated to the accounts of the employees. At the end of 1984, the Fund held almost 63 million shares of Sears stock, or more than 17% of the total outstanding shares. The employees are able to instruct the Trustees on how to vote their stock at the shareholders' meetings.

Upon termination of employment or retirement, the employee's entire account balance is distributed in a lump sum. Sears stock credited to the employee's account is distributable in kind. Under present tax law, the lump sum distribution is taxed under the special 10-year forward averaging method, and pre-1974 accumulations are eligible for capital gains treatment. Unrealized appreciation in distributed Sears stock is not taxed until it is actually realized. The distributions are used by the retirees to provide for their retirement security. Over the years, the Fund has distributed almost $5-3/4 billion in excess of employee deposits to withdrawing members.

The Company also has a Pension Plan which, together with Profit Sharing, provides for a balanced retirement program for thousands of retirees.

1. The Need For Lump Sum Distributions From Profit Sharing Plans

A primary objective of a profit sharing plan is to provide an accumulation of retirement capital and not necessarily a form of retirement payments in a fixed stream. This retirement capital allows the retired employee to maintain the flexibility needed to meet changing conditions during retirement. It also allows the retiree to protect himself against the ravages of inflation. Therefore, Sears Profit Sharing Fund, like most profit sharing plans, provides for lump sum distributions to retirees.

The need for a lump sum distribution, as opposed to an installment or annuity method of distribution, stems from the traditional principles of private ownership of property. A corollary to the right of private ownership is the right to control and to use one's own property as one sees fit, subject only to those legal limitations necessary to protect the rights of others.

An employee is the beneficial owner of his profit sharing account and assumes all the risks of ownership during his working career, including the risks of gain or loss. Therefore, as in the case of all other property rights, he should have the right to choose the manner of distribution of his account. The employee may wish to purchase a new home, pay off the mortgage on his home, make substantial purchases of investments, pay for his children's higher education, etc. In the alternative, the employee may wish to rollover to an IRA. Lump sum distributions enable the employee to accomplish these objectives. In addition, lump sum distributions give retirees a capital sum to invest, and, therefore, have a stimulating effect on the economy of the nation, and give the retired employee investment flexibility so he can protect himself against inflation.

Although retirees may rollover their lump sums to an IRA, many, particularly the middle and lower income employees, elect to keep their funds. Rollovers are usually utilized by those retirees with larger lump sum distributions.

2. The Need For Favorable Tax Treatment For Lump Sum Distributions

A lump sum distribution represents "bunched" income accumulated over a number of years, and it would be inequitable to subject such income to the highest marginal tax brackets in the year of retirement. The distribution often represents the end product of the employee's own savings and his profit sharing benefits over his working career. The employee looks forward to the lump sum, and it represents a major part of his savings for retirement security.

For well over 40 years, the tax laws have provided special tax treatment for lump sum distributions in order to avoid confiscatory tax on them.

The present tax treatment--special 10-year forward averaging and capital gains treatment on pre-1974 accumulations--recognizes the need for equitable taxation of lump sum distributions. Without this special treatment, a retiree may pay more tax in the year of retirement than if he had paid tax each year on his annual credits.

Rollovers to IRAs are utilized by many employees to defer the tax on their distributions. However, many thousands of Sears employees do not rollover. Many Sears employees believe a rollover eliminates much of the flexibility presently available under lump sum distributions. Sears employees often retain their distributed Sears stock, and use the dividends to supplement their other retirement income. With a rollover, this can be impractical because of IRA maintenance fees and other costs. This is especially true for smaller and medium size accounts. IRS rollovers are more attractive to the higher-paid employees who may have other assets and income to provide for their retirement income replacement.

3. The Need For The Exclusion From Taxation Of Unrealized Appreciation

Sears Profit Sharing Fund invests a substantial portion of its assets in Sears stock in order to provide the employees with a direct proprietary interest and, therefore, a greater incentive to work for the success of the Company. The stock is purchased for the accounts of the individual employees, it is held as the employee's property, and it is finally distributed, in kind, as part of the lump sum distribution. The unrealized appreciation, consisting of the excess of the market value of the Sears stock over its original cost price, is not taxed under present law at the time of distribution. Instead, the employee is taxed when he subsequently realizes the appreciation through a sale or other taxable disposition.

Deferral of tax on unrealized appreciation is sound for three reasons. First, the employee should not be taxed until the appreciation is realized, and there is no realization simply because stock has been withdrawn from a profit sharing trust. Second, it would impose an unwarranted hardship on the employee to tax him before he has converted the stock into cash. Finally, it would produce erratic results. Each of these points is discussed below.

Income Is Not Realized

When the employee withdraws from a profit sharing plan and takes his securities, the appreciation in value of the securities is not realized at that time, and will not be realized until he sells the securities and obtains cash or other property for it. At the time of such sale, the employee will be taxed. Likewise, individual purchasers of securities are not taxed until the appreciation in value on such personally held securities is realized through a sale or other taxable transaction. Thus, with regard to appreciation, under current law employees purchasing the securities of their employer by participating in a qualified profit sharing plan are placed in the same position as those individuals acquiring securities directly.

Income or gain is normally taxed when realized. However, the Internal Revenue Code provides in a number of cases that income shall not be recognized and taxed even though such income is theoretically realized. For example, an exchange of income producing properties of like kind, or a sale of a personal residence and purchase of a new residence with the sales proceeds, are realizations of income not subject to tax under special non-recognition provisions. One of the basic reasons for the non-recognition of gain in these cases is founded on the principle that a mere change in the form or identity of an asset is not a taxable event and the gain should not be subjected to tax.

The case is even stronger for not taxing unrealized appreciation in stock distributed in kind, at the time of distribution, than it is for non-taxation in the above examples. At the time of distribution of the stock, there is no exchange, no sale and reinvestment, and no conversion of assets. There is no realization of income upon distribution because the employee is merely receiving property which has been his all along. No income is created or tangibly realized when the employee's "nominee" (his trustee) transfers his property to him. It is realized only upon a subsequent sale or other taxable exchange.

Serious Hardship if Appreciation is Taxed

Serious hardship would be imposed on the employee if the tax were based on the appreciated value of distributed employer's securities. Frequently, the employee would not have the cash to pay the tax and would be forced either to borrow money, or else to liquidate a portion of his investment in order to pay the tax. In either case, his retirement security would be impaired.

Erratic Results

If the employee had to pay a tax on the market value of the employer's stock distributed to him, the tax would vary greatly depending on the value of the stock at the time of withdrawal. Thus, if the price is at a high point when the employee retires, he would pay more tax. For example, two employees might retire within a few weeks of each other and yet incur widely different tax liabilities even though they each received the same number of shares and have the same average cost price for such stock. The recent fluctuations of the stock market highlight the importance of this consideration. The fluctuation in market values can be illustrated by the fact that in the last year, Sears stock has traded from a low of 29-3/4 to a high of 39-1/8. Further, this situation would cause an employee to speculate on the time of his retirement and his selection of a retirement date would depend to a great extent on fluctuations in the value of the stock. This would disrupt orderly retirement planning and would tend to create instability in the labor market.

4. Investment in Employer Stock Should Be Encouraged

Present law recognizes the importance of providing incentive for investment by profit sharing plans in the stock of the employer company. Taxing unrealized appreciation would discourage investments in stock of the employer corporation by profit sharing plans. This would in turn substantially reduce this very important employee incentive which makes the employee a true partner in the success of his employer's business. Further, it would decrease the desirable trend toward wider ownership of American industry.

The incentives provided by employee ownership are well recognized. For example, the President's tax proposals dealing with the revised rules for leveraged ESOPs state in part "direct ownership of employer securities, with the attendant rights and benefits, is far more likely to be an incentive for employee productivity than a speculative benefit to be realized only upon separation from service". A Sears Profit Sharing Fund member is the owner of the Sears stock credited to his account. The dividends on the shares are credited to him and reinvested in more stock for his account. The Fund member has the right to vote his stock at all shareholders' meetings.

Sears Fund members have all the attendant rights and benefits of stock ownership. They have full beneficial ownership of the stock, and only the legal title is held by their trustees. This employee ownership of the Company has contributed to the success of the Company and has rewarded the employee owners.

5. Section 401(k) Employee Elective Contribution Limit and New Antidiscrimination Test

The Sears Profit Sharing Fund was amended on January 1, 1984, to provide for pre-tax deposits under Section 401(k). The employee can first make pre-tax basic deposits of 3% or 5% of his compensation. After making pre-tax basic deposits of 5%, the employee can make additional pre-tax deposits of 1% to 5% of compensation. In addition, after making 5% pre-tax basic deposits, employees may elect an additional 1% to 10% of remaining pay as after-tax deposits. No partial withdrawals are permitted from the pre-tax accounts prior to age 59-1/2.

As a result of the change, 1984 employee deposits and savings increased by almost 50% as compared to 1983. In 1983, when only after-tax deposits could be made, the employees deposited $204.5 million in basic deposits and $61.3 million in voluntary deposits for a total of $265.8 million. In 1984, employee deposits increased as follows:

Pre-tax Basic (3% or 5%)	$202.5 Million
Additional Pre-Tax (6% to 10%)	67.4
Total Pre-tax	$269.9
After-tax Deposits	120.8
Total Deposits	$390.7

The increase in deposits illustrates the additional savings and investments made by Sears employees as a result of the change to a Section 401(k) cash or deferred arrangement.

The tax proposals would place an $8,000 maximum amount in any one year for an employee's elective contributions to a Section 401(k) plan, including the employee's IRA contribution. While it is true that relatively few Sears employees would be affected by the proposed maximum limit, this proposed change is contrary to the Administration's stated goal of providing incentives for savings. Moreover, the cap is only part of the problem. The proposed changes in the antidiscrimination rules and method for calculating the actual deferral percentage (ADP) for the higher-compensated group would result in changes that could affect all employees. The proposed antidiscrimination rule would be so difficult to administer that the result would be that the maximum rate of elective contributions would have to be cut back for all employees.

Under our Plan, our employees make their election of the percentage of income they wish to contribute as pre-tax deposits in November preceding the plan year. At this time, we have no way of knowing or determining who will be in the prohibited group during the following year. Since the proposals do not provide any safe harbors, we will probably be forced to reduce the maximum contribution rate for all employees. In effect, we will be forced to attempt to calculate our own safe harbor by penalizing all employees.

The revision in the ADP is not needed. A reasonable cap on the amount of the elective contribution is sufficient in itself to prevent discrimination in favor of the higher-compensated employees. The proposed maximum of only the first $200,000 of compensation being considered in calculating the ADP, combined with the $8,000 cap, would result in a maximum pre-tax deposit rate of only 4% for employees earning over $200,000. The proposal for revising the ADP is nothing more than an overkill, and the result is that the lower-compensated employees will be cut back on their maximum pre-tax deposit rate. This would reduce the savings that members are presently making for their retirement security.

6. Recovery of After-Tax Deposits Upon a Partial Withdrawal

The Treasury tax proposals would change the method of calculating the return of employees' after-tax deposits made after December 31, 1985, when the employee makes a partial withdrawal.

Under present tax law, a partial withdrawal from the Profit Sharing Fund is taxed as ordinary income to the extent it exceeds the employee's after-tax deposits not previously withdrawn. Under the proposals, employee after-tax deposits made before January 1, 1986, would continue to be considered as the first amounts withdrawn in a partial withdrawal and, therefore, non-taxable. Thereafter, all partial withdrawals from the Fund would be considered first a return of income and then a return of after-tax deposits.

There is no valid reason for changing the rules on recovery of employee deposits on partial withdrawals. The provisions governing the calculation of taxable income on a partial withdrawal have been in the tax laws for years, and have remained unchanged through many major changes in the Code.

It is not clear whether the income to be taxed to an employee upon a partial withdrawal will also include Company contributions, but it will clearly result in additional complexities in the law and be difficult to administer. Further, it will discourage participation by all employees, especially the younger ones. These employees would be depositing their after-tax deposits in the Fund, and when they make a partial withdrawal for any reason, including a hardship withdrawal, they would be subject to tax again. Many employees, if they save at all, would rather put their savings in a personal savings account that could be withdrawn without paying tax on the same amounts again.

The overall effect of the proposals is to discourage savings and participation in the Profit Sharing Fund. It is true that many employees make partial withdrawals during employment. However, most still dedicate a major part of their savings to retirement.

7. Penalties on Withdrawals

The President's proposals would subject any withdrawal before age 59-1/2 to an additional 20% penalty tax. The penalties would apply to both complete withdrawals upon early retirement or termination of employment, and to partial withdrawals. If the withdrawal was made to pay for a dependent's college expenses, for purchase of the employee's first principal residence or to replace unemployment benefits during a period of unemployment following the cessation of such benefits, the additional tax would be 10%.

The purported reason for the penalty proposal is to reduce the use of qualified profit sharing plans as "short-term savings programs rather than as retirement savings vehicles".

The proposal for an early distribution penalty fails to recognize the fact that many thousands of employees retire before age 59-1/2. The proposals would penalize all of these early retirees. In 1984, over 2,000 Sears and Allstate employees retired under age 60, and if this provision was in the law in 1984, all of these retirees would be subject to the early distribution penalty unless they rolled over to an IRA.

Further, the proposals would impose a lesser penalty for certain types of partial withdrawals, such as those to pay for children's college expenses and to purchase a home. In these cases, the penalty would be 10%. However, the proposals ignore true hardship withdrawals. For example, a withdrawal to pay for unreimbursed medical care would be subject to the full 20% additional penalty.

The result of the additional penalty tax is that employees who must make partial withdrawals will make larger withdrawals in order to pay the additional penalty tax. This will leave them with less in their accounts for retirement.

The early distribution penalty on early distributions would adversely affect women who are apt to go in and out of the labor force more often than men.

The proposals would also levy a 10% penalty tax on the portion of all taxable benefits received after age 59-1/2 on amounts in excess of $112,500 in any one year, including lump sum distributions, pensions, and IRA distributions.

This proposal would be a penalty on success. The employee has both the risk of gain and the risk of loss on his investments in his Profit Sharing Account. Under this proposal, if the investments are successful, the employee will be penalized.

Many retirees would be subject to this 10% additional penalty tax on their distributions. For example, in 1984, approximately 600 employees retired from the Company with a profit on their Fund withdrawals in excess of $112,500. Under the Administration's proposal, all of these retirees would be subject to the penalty tax unless they rolled over to an IRA. Because of recently increased employee savings in the Fund, in future years this number could be larger. The imposition of the penalty would be erratic. If the market value of Sears stock was high at the time of distribution, there would be a larger penalty tax. This would encourage employees to speculate on their retirement dates so as to attempt to retire when the market is lower and thereby minimize the 10% penalty tax.

8. Proposed Antidiscrimination Rules-Qualified Retirement Plans

The President's tax proposals include a recommendation to eliminate the present nondiscriminatory classification eligibility rule under Section 410(b)(1)(B) (the "fair cross-section" test), and substitute a new test providing for "125% coverage". This new test would specifically define the prohibited group to consist of the top 10% of total employees by compensation in the controlled group. The rule would require that the percentage of covered prohibited group employees in any one plan to total controlled group prohibited group employees could not exceed 125% of the percentage of other covered employees to total other controlled group employees.

The effect of this proposed change is that employers in the controlled group who maintain separate Pension Plans for their own employees may find their Plans will fail the nondiscrimination test if that particular employer has a higher salary scale for its employees than the scale for the balance of the employees in the controlled group.

In the Sears controlled group, four employers maintain separate Plans for their own employees for competitive reasons. It appears that at least two and possibly three or more Plans in our controlled group, Plans which cover more than 40,000 employees, would fail to qualify under the proposed new antidiscrimination rules. These are Plans that cover virtually all of the eligible employees of the specific employers.

The present nondiscriminatory classification test has been in the tax laws for years. The ostensible reason stated for repealing the rule is that the "nondiscriminatory coverage test of current law fails adequately to assure that the tax advantages of qualified plans are available only where coverage is provided on a broad, nondiscriminatory basis". And, based on this reasoning, the President's tax proposals would result in the disqualification of Plans covering 40,000 employees, all of the employees of each particular employer.

Recommendations of this sort certainly have no place in proposals designed to promote fairness, growth, and simplicity in our tax laws.

9. Antidiscrimination Rules for Other Employee Benefits

The President's tax proposals provide for uniform antidiscrimination rules for employee benefits other than qualified retirement plans. The proposal adopts the same prohibited and non-prohibited groups described above and then provides for three antidiscrimination rules. The rules relate to actual coverage of the benefit among employees, availability of the benefit to employees and the amount of the benefit received by employees.

Employee Discounts

Sears gives a discount on the merchandise and services it sells to all its employess, both full and part-time. It also gives the discount to employees of companies affiliated with Sears on October 5, 1983. The discount is 10% on most items of merchandise and services, and 15% on certain soft lines. The rate of discount is the same for all employees regardless of their compensation. Employees of affiliates either formed or acquired after October 5, 1983, are not eligible for a non-taxable discount because of the provisions of the Tax Reform Act of 1984 limiting tax-free employee discounts to employees in the line of business where the merchandise or services are sold to the public. A grandfather clause permits us to give the non-taxable discount to employees of companies affiliated with Sears on October 5, 1983.

The most serious problem with the President's proposal for employee discount is the requirement that the average benefit given to members of the prohibited group cannot exceed 125% of the average benefit given to the non-prohibited group. The very nature of an employee discount does not lend itself to such a restriction. The amount of employee discount that an employee receives is determined by the amount of purchases that he makes from Sears. A person who earns more money may buy more from Sears, and probably buy higher-priced items than a lower-paid employee, however, there is no effective way to control this.

Putting a limit upon the amount of discount that a member of the prohibited group can receive would not solve the problem because this would not control the average purchase by the members of the non-prohibited group which, in turn, determines the limit for the prohibited group. Putting a limit on the amount of the discount that any employee can receive would not be practical for a company the size of Sears. When an employee makes a purchase at any Sears store in the country, he is given a discount after properly identifying himself as an employee. No record is kept identifying the employee and the amount of the discount given unless it is a credit sale, and then only incidentally to see that the employee's credit account is charged with the proper amount. Furthermore, it would be a Herculean task to keep track of each discount given and identifying the recipient as either a member of the prohibited group or the non-prohibited group. The cost of such a system, even if possible to design and implement, would be unwarranted in order to meet the dubious goal of proving that members of the prohibited group do not receive a discount in excess of 125% of the amount received by the non-prohibited group. If those restrictions are enacted into law, Sears would probably be forced to discontinue giving employee discounts.

There is an additional problem with the proposed antidiscrimination rules that would treat Sears discount plan discriminatory. All employees in the controlled group are treated as employed by one employer in determining whether the coverage rules are met. This means that the discount would have to be extended to employees of all companies in our affiliated group. Yet Section 132 limits the discount to employees in the merchandise line of business. This probably is not a problem at the moment because of our ability to give the discount to employees of affiliated companies under the grandfather clause in the Tax Reform Act of 1984. However, as time goes on, this will undoubtedly become a problem. The provisions of the Tax Reform Act of 1984 and the President's proposal are contradictory on this point.

Medical Plan

The antidiscrimination rules cause problems for Sears medical plan in several regards. Sears medical plan does not presently cover part-time employees. Although the President's proposal permits exclusion of part-time employees, its definition of what constitutes a part-time employee is too restrictive. Many of Sears part-time employees work more than 20 hours a week, but meet the current definition of part-time employees contained in Treasury Department regulations. The existing definition of a part-time and seasonal employee appears to be fair. There is no policy reason to make this change in definition. It would be extremely costly for industries, such as retailing which utilizes many part-time and seasonal employees, to provide medical insurance for them. Also, many of these employees are already covered by plans carried by parents and/or spouses of employees.

Even if Sears were to cover part-time employees in its medical plan, it is questionable whether enough of these employees would join the plan, especially if they are charged more than full-time employees as permitted under the President's proposal. As stated above, many of these employees do not need or desire such coverage because they are already covered under medical plans of their parents and/or spouses. Even though the proposal says that the Treasury will provide rules to solve this situation, it is not fair to companies to have to wait for regulations to determine if their plans qualify. Furthermore, any rule developed by the Treasury Department would undoubtedly require proof as to the reason an employee did not join the plan. We do not believe that Sears should be required to force an employee to disclose the reason that they choose not to participate in a particular benefit plan.

Group Life Insurance

Still another Sears employee benefit that may be adversely affected by the new antidiscrimination rules is group life insurance. The new rule requires that the percentage of employees in the prohibited group that benefit from a plan not exceed the percentage of employees in the non-prohibited group by 125%. By its very nature, life insurance is more attractive to older employees with family responsibilities. Since the plan requires a contribution by participants, younger employees, especially those without family responsibilities, tend not to join. Younger employees also are more likely to be in the non-prohibited group since they have not been in the work force long. Although there are no statistics available, it is safe to predict that participation by members of the prohibited group will exceed participation by members of the non-prohibited group by more than 125%. Although younger employees may not participate in

> group life insurance now, when they grow older and take on more family responsibilities they will join the plan.

It appears that the basic flaw of the antidiscrimination rules is the attempt to apply a uniform rule to diverse types of benefit plans. Each benefit plan has its own unique features, and the test to determine whether a particular plan discriminates in favor of highly-compensated employees must be tailored to each plan. For example, with employee discounts, the rate of discount offered members of the prohibited and non-prohibited group of employees is the true test of discrimination, not the dollar amount of discount.

Different companies within an affiliated group of companies should be allowed to design their own balanced benefit program, taking into consideration the needs and desires of their own employees and benefits given by competitors in their own industry. Rules already exist to require each company to have a fair cross-section of employees to insure that separate companies are not utilized to set up discriminatory plans. There is no need for a broad rule requiring treating all employees in an affiliated group as employees of the same company.

The whole area of employee benefits was thoroughly studied during the enactment of the Tax Reform Act of 1984, and rules relating to discrimination were made law then. Employers have hardly had time to review and revise their plans to comply with these rules. Congress should not hastily enact or revise these rules. With all the important decisions that must be made in the whole tax reform proposal, there is not sufficient time to fairly analyze the employee benefit area.

Conclusion

The effect of the President's tax proposals dealing with retirement savings will reduce the incentive for Sears employees to join our Profit Sharing Fund and make savings for their retirement security. Over the years, literally thousands of Sears employees have retired with capital sums to provide them with retirement security.

The retirement savings proposals pick up relatively modest amounts of revenue according to the Treasury projections. The harm they do to retirement planning and disappointment to employee savings objectives more than offsets any possible revenue gain. Millions of Americans have been saving for years under guidelines previously established by the Government. Changing the rules now would be a breach of faith for those nearing the end of their career, and a clear indication to younger employees that they cannot plan with any assurance that the Government will not change the law again. These recommendations could and should be deleted from the President's tax proposals. This could be done without damage to the overall objectives of the package.

Sears strongly urges the Committee to reject all of the proposals that would change the existing tax treatment for Sears Profit Sharing Fund members on their participation in and benefits from the Fund.

STATEMENT OF

NANNERL O. KEOHANE, PRESIDENT OF WELLESLEY COLLEGE

BEFORE THE

COMMITTEE ON FINANCE OF THE U.S. SENATE

ON

TAX REFORM: THE APPROPRIATE VALUATION AND TAXATION OF FACULTY HOUSING PROGRAMS MAINTAINED BY EDUCATIONAL INSTITUTIONS

AUGUST 2, 1985

This statement is being submitted by Nannerl O. Keohane, President of Wellesley College, Wellesley, Massachusetts, for the hearing record of the Senate Committee on Finance, July 19, 1985. It is filed on behalf of Amherst College, Smith College, Wellesley College, Wesleyan University, and the following educational associations:

American Association of State Colleges and Universities
American Association of University Professors
American Council on Education
Association of American Universities
Association of Catholic Colleges and Universities
Council of Independent Colleges
Federation of Independent Illinois Colleges and Universities
Independent Colleges and Universities of Missouri
National Association of College and University Business Officers
National Association of Equal Opportunity in Higher Education
National Association of Independent Colleges and Universities
National Association of Independent Schools
National Association of Schools and Colleges of the United Methodist Church
National Association of State Universities and Land-Grant Colleges

Testimony on this issue was originally presented by President Keohane before this Committee on June 22, 1983; a statement on faculty housing was also submitted to the Committee by President Colin G. Campbell of Wesleyan University in July 1984.

President Jill K. Conway of Smith College has testified on faculty housing before the Subcommittee on Select Revenue Measures of the House Ways & Means Committee on November 2, 1983. President Keohane most recently appeared before the House Ways and Means Committee on July 10, 1985 to urge action on this subject. While we are aware that the purpose of these hearings is to examine President Reagan's specific proposals for tax reform, it is quite clear that these hearings provide the forum for critical appraisal of related aspects of our tax system in need of adjustment. One such aspect is the treatment by the Internal Revenue Service of faculty housing programs.

The Tax Reform Act of 1984, in section 531(g), states in general that any regulation providing for the inclusion in gross income of the excess (if any) of the fair market value of faculty housing over the operating costs incurred in furnishing such housing (or, if higher, over the rent received) shall not be issued before January 1, 1986. The provision, which was inserted in the bill by the Senate Committee on Finance, applies to faculty housing furnished in 1984 and 1985, but by its terms is not applicable to housing furnished in years before 1984 or after 1985.

Previously, in November 1983, the Subcommittee on Select Revenue Measures had reported favorably a bill (H.R. 677) that would have applied a rule reaching substantially the same result to years before 1984. A similar rule for years before 1984 was approved by the Committee on Finance in October 1982 as section 202 of H.R. 7094. The status of the matter with respect to pre-1984 or post-1985 years was ruled by the Chairman of the conference on the Tax Reform Act of 1984 not to be within the scope of the conference. The Conference Report states that "No inference is intended by imposition of a moratorium for such period [i.e., 1984-1985] as to the proper income tax treatment of faculty housing prior to 1984 or after 1985" (p. 1172). The issue for pre-1984 and post-1985 years thus remains to be decided.

We respectfully submit that the moratorium in section 531(g) that is applicable to faculty housing in the years 1984 and 1985 should be extended by Congress to the years prior to 1984. In addition, the rule provided in the moratorium, or some comparable rule reasonably capable of administration by the colleges and the Internal Revenue Service, should be adopted for years after 1985.

In the discussion that follows, we provide support for the conclusion that the moratorium's "cost" standard is reasonable and appropriate and that the IRS has used unpredictable and inappropriate standards in the past for asserting withholding tax liability arising from traditional faculty housing programs.

First, we begin with a brief description of the faculty housing program offered by Wellesley College, as background for consideration of the legal aspects of this issue.

Second, we recite congressional mandates calling for regulations governing valuation of taxable fringe benefits that will provide "appropriate and helpful rules," and we refer to the Supreme Court's admonition that an employer's obligation to withhold must "be precise and not speculative."

Third, we show that the IRS has failed to meet these directives: The only relevant IRS rulings refer to state lodging valuations (for state unemployment tax purposes), which are substantially less than the rentals here involved, and which have been completely ignored in the Service's treatment of faculty housing programs.

Fourth, we describe how the standards which have been adopted by the Service for valuing faculty housing have been inconsistent and disparate.

Fifth, we analyze the only case law on this subject, to show that it is devoid of any guidance on the appropriate measure for valuing faculty housing.

Sixth, we examine for precedent and guidance the rule which the Treasury has recently stated it will apply in another area of employee benefit issues, involving the use of company-owned aircraft.

Finally, we conclude that the moratorium's "cost" standard is fair and reasonable, furnishes a feasible administrative standard, is supported by precedent, and is particularly appropriate for nonprofit institutions. We also suggest the availability of alternatives which would at least provide a reasonable and predictable basis for applying traditional tax rules in this area

I. Wellesley's Faculty Housing Program

Wellesley operates a faculty housing program that rents houses and apartments to approximately 110 faculty members and certain administrators (for example, deans) and their families. The College maintains the program in order to have a substantial number of faculty members and administrators living on or near campus as part of an extended campus community -- one that is conducive to informal interactions between faculty members and students. This sense of community has long been an integral part of the educational experience at Wellesley as a small, residential, liberal arts college. Yet whether an educational institution is located in a rural, suburban or urban setting a traditional faculty housing program, by creating a sense of collegiality among the faculty members and by encouraging student-faculty interaction outside the classroom, serves important educational goals of the institution.

During the 19th century Wellesley generally required all faculty members to live on campus. The President's report of 1900 stated that this practice

> "brought a body of intelligent and cultivated women into close contact with the student body, much to the advantage of the latter. The intercourse thus established has been helpful and beneficial in the highest degree. The spirit of unity and helpfulness has been largely fostered by this method of living . . . "

Although times have changed considerably since 1900, and Wellesley is no longer able to have its entire faculty residing on campus, the faculty housing program continues to serve our educational objectives by having substantial numbers of faculty living on or near campus.

Wellesley's housing program is accurately described as a "traditional" faculty housing program because it resembles the housing programs that exist and have existed for many years at numerous colleges, universities, and secondary schools across the country. Under Wellesley's program, housing is rented to faculty members at a substantial rent that reflects the College's cost of providing the housing, the educational purposes of the College served by having faculty members living on or near campus, and the value of the housing to the College's faculty members. No substitute cash living allowance is provided to employees who elect not to live in faculty housing.

II. Background

Wellesley and other colleges and universities have maintained that participation in faculty housing programs does not give rise to income to the employee-tenants, that the programs were covered by the moratorium on fringe benefit regulations imposed by Congress since 1978, and that in any event any income to employee-tenants does not constitute "wages" subject to withholding tax liability of employers or to employment taxes.

The Internal Revenue Service has maintained, to the contrary, that the excess (if any) of fair rental value of each faculty housing unit over the rental charged is income to the employee, is not covered by the previous Congressional moratorium, and is subject to withholding by the employer-college and to employement taxes. It has issued thirty-day letters to the four institutions mentioned above for years beginning with 1973 and 1974. But, so far as we have been able to determine, the IRS is not asserting a similar claim against any other colleges maintaining similar faculty housing programs.

III. Valuation rules are needed and mandated, but the Internal Revenue Service has not yet provided any clear rules.

The House Committee report accompanying the new Code section 132, relating to fringe benefits, states:

> "For purposes of assisting both taxpayers and the IRS, the Treasury is to issue regulations setting forth

> appropriate and helpful rules for the valuation of taxable fringe benefits, and coordinating the applications of sections 61 and 83." (p. 1609)

The Conference Report confirms this statement (p. 1169).[1]

In Central Illinois Public Service Co. v. U.S., 435 U.S. 21 (1978), the Supreme Court said that "because the employer is in a secondary position as to liability for any tax of the employee, it is a matter of obvious concern that, absent further specific action, the employer's obligation to withhold be precise and not speculative." (435 U.S. at 31 (emphasis added).)

The Service has not heretofore provided any such "appropriate and helpful rules for the valuation" of the some 600 faculty housing units maintained by the four colleges or by any other nonprofit educational institutions. Nor has the Service provided guidance that would make the college employer's withholding obligation "precise and not speculative." The employers have thus been left with little or no guidance by the Service regarding the appropriate rentals to be charged or the amounts subject to withholding or employment taxes if the rentals actually charged are ultimately determined to have been insufficient.

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[1] The congressional committee reports accompanying the fringe benefit moratoriums enacted in 1978, 1979 and 1981 repeatedly noted that "both taxpayers and the Internal Revenue Service must face difficult problems of valuing benefits provided in kind." See, e.g., Sen. Rept. No. 96-433 (1979), 1980-1 C.B. 486, 488.

The only specific guidance furnished by the Service with respect to valuing meals and lodging furnished by employers was set forth in Rev. Rul. 68-321, 1968-1 C.B. 415 and Rev. Rul. 68-322, 1968-1 C.B. 416, and later clarified in Rev. Rul. 76-148, 1976-1 C.B. 310. In the first ruling, dealing with the value of meals furnished to employees, the Service ruled:

> "With respect to the amount to be included in wages for Federal employment tax purposes, the Service has placed no specific valuation on meals furnished to employee as part of their compensation, but will take into consideration the approved valuation of meals by the several States where the States have laws or regulations relative to such valuation. Where the States have no such laws or regulations providing for such valuation, the Service will recognize that amount which is the reasonable prevailing value of the meals, taking into consideration all surrounding circumstances, such as the value which the employer charges on his books of account, if the accounts are regularly kept, any agreement which may exist between the employer and the employee relative to the value of the meals, the place where the meals are served, and the nature of the service, etc. The cost of the meals to the employer is not, in and of itself, determinative of the fair value. No single one of the above-mentioned considerations is conclusive but may be a factor in determining the fair value to be placed on the meals so furnished. [Emphasis added.]

In the second ruling the Service, with respect to meals and lodging furnished by a college sorority to student-employees, stated:

> "The Internal Revenue Service has placed no specific valuation on meals furnished to an employee as part of his compensation. However, Revenue Ruling 68-321, Page 415, this Bulletin, sets forth the factors that should be considered in determining the fair value of the meals. In compuing the fair value of lodging, all pertinent factors should similary be considered. The cost of the meals and lodging to the sorority is not in

> and of itself determinative of the value of these items for Federal employment tax purposes." [Emphasis added.]

Rev. Rul. 68-321 was "clarified" by the Service in Rev. Rul. 76-148, supra, which concluded:

> "Accordingly, although the State valuation of meals is taken into consideration, it is not exclusively determinative of the value of such meals furnished as part of the employee's compensation, for purposes of the Federal Insurance Contributions Act, the Federal Unemployment Tax Act, and the Collection of Income Tax at Source on Wages.
>
> "Rev. Rul. 68-321 is clarified."

Thus, this 1976 ruling indicated that:

(1) The Service thought that before its clarification the 1968 ruling could be taken to mean that the state valuation of meals (and, similarly, lodging) would be treated as "exclusively determinative" for federal tax purposes; and

(2) For the future, the state valuation would be "taken into consideration" but would not be conclusively determinative.

Yet the Service asserts withholding liability against the four institutions even for the periods prior to the 1976 clarification and has failed to set forth for future years any "appropriate and helpful rules" to guide employers or Service personnel in the field.

Thus while referring to, among other items, the value regularly charged on the employer's books, any employer-employee agreement relative to value, and the employer's cost, the 1968 and 1976 rulings, taken together, state a Service position that it would take into consideration the approved valuation of meals, and similarly lodging, by the several states where the states have laws or regulations relative to such valuation. The states have a significant interest in the issue of board and lodging because most of the unemployment insurance taxes (FUTA) flow to the states. The interest of the states was particularly acute because from the earliest days of FICA and FUTA the IRS ruled that board and lodging were subject to employment taxes even if they were exempt from income tax under section 119 because they were furnished for the convenience of the employer. This position was ultimately held by the Supreme Court to be incorrect in Rowan Companies v. U.S., 452 U.S. 247 (1981), but the interest of the states continues with respect to board and lodging not excluded from taxation by section 119.

The CCH Unemployment Insurance Reports (¶ 1215) show the values currently placed by each of the 50 states and the District of Columbia on meals and lodging combined, on meals alone, and on lodging alone. A review of this summary table shows the following:

1. While the values vary from state to state, the table shows that more than two-thirds of the states place a value on lodging at $20 per week (roughly $87 per month) or less, and more than half use $10 per week (roughly $43 per month) or less. Only three states use

values of more than $25 per week (roughly $110 per month).

By contrast the rental values asserted by IRS for the years 1973 and 1974 for the faculty housing average some $60 per week, or some $250 per month, and range up to nearly $900 per month, far beyond the guidelines prevailing in the state rules. For subsequent years IRS is using steadily increasing amounts.

2. In Massachusetts, where three of the four colleges involved in the pending audits are located, lodging is valued at $10 per week; in Connecticut, where the fourth college is located, lodging for a single room is valued at $4 per week (shared room $3 a week). The Massachusetts value applies, according to the state regulations, "until and unless in a given case a rate for board and lodging is determined by the [state] Director"; the Connecticut regulation states that "Where lodging consisting of more than one room is provided, the administrator shall establish a reasonable value for such lodging."

3. A few of the states, such as Missouri, Texas and Utah, do not set a guideline figure, and since we have not studied all the state regulations some may, as in the case of Massachusetts, permit special determination by the state authorities in particular cases. Florida, for example, provides that "Lodging

shall be deemed to have not less than one-half the fair market value of such lodging to the general public. Fair market value being the rental value of such lodging to the general public." California regulations state that "As a general rule, * * * the department will consider a reasonably estimated cash value of lodging to an employee, for the calendar year 1984 and thereafter except as modified in accordance with this subdivision, to be 66-2/3 percent of the ordinary rental value to the public but not in excess of $400 per month or less than $12.95 per week."

Without dwelling on the details of the various state rules, it is obvious that the rules of thumb provided administratively by the states employ values well below the arm's length amounts generally associated with the concept of "fair market value." A figure of $10 per week or less, used by a majority of the states, represents less than 7-1/2 percent of the minimum wage ($3.35 per hour, or $134 per week for a 40-hour week), far less than the amount normally budgeted for lodging; and it would be a substantially lower proportion of an average wage. Indeed, it seems to be clear that if a convenient rule of thumb is to be used to cover a multitude of cases, some leeway is administratively necessary for employers to use or else endless controversy would exist. Florida and California, for example, have used one-half or two-thirds of full value.

It is clear that, in the case of the four colleges, the IRS has not followed its own statement in Rev. Ruls. 68-321, 68-322 and 76-148, supra, to the effect that it "will take into consideration the approved valuation" of meals and lodging set by the state. It has wholly ignored the Massachusetts and Connecticut lodging values.

IV. The IRS assertions of tax liability against the four colleges have reflected inconsistent and disparate approaches to the determination of rental values of the various faculty housing units.

Instead of taking into consideration state lodging valuation rules set by Massachusetts and Connecticut, and other factors (such as cost) discussed in the rulings cited above, the IRS has sent two IRS valuation engineers, one for each state, to determine the fair rental value of each of some 600 rental units, both houses and apartments, at the four colleges. The engineers have made diligent efforts to cope with the problem, but the absence of National Office guidelines and the magnitude of detail involved has led to internal inconsistencies and discrepancies in their reports.

For example, the Connecticut engineer calculated a rental value by taking the last previous real estate tax assessment in 1964, multiplying it by a factor to produce a fair market value in the year in question, and then applying an assumed rate of return on that value to produce the monthly rental figure he deemed fair. The Massachusetts engineer used a similar approach in the early part of his reports, and then rejected it because he concluded it produced too high a rental; he then used lesser figures but still higher in most instances than the rents actually charged by the colleges.

As another illustration: In one report a total rental value has been applied to each apartment house, and then divided by the number of apartment units in the building, to fix an equal rental for each unit, regardless of its size. In another report the rental values assigned to each apartment unit in the building vary significantly according to the number of bedrooms in each unit, regardless of whether the apartment is located in the basement or on the top floor and regardless of the total square footage of space in the apartment.

There are other differences and discrepancies in the four reports. Suffice it for present purposes to note that no college executive would have been able to foretell the method of fixing rents for each of a large number of faculty housing units that would satisfy IRS examiners who would ignore the state lodging valuations and have no National Office guidelines to follow. In fact, in some instances the IRS engineers established rentals less than those being charged by the college, indicating that in the IRS view the college was overcharging those tenants. Moreover, in other cases, while the colleges have naturally sought to maintain rentals for their various faculty units that in their best judgments are relative to each other, according to size, location, etc., the IRS has set rental values that vary from less than one percent to more than 300 percent above the rent charged. And the excess of the IRS figure over the rent charged bears no relationship to the salary of the tenant. Thus the IRS differs from the colleges not only in the aggregate level of appropriate rents but to a substantial extent in the relative rental values of the various units.

It is not sufficient for the IRS or the college to set the aggregate rental values; rents for each unit must be fixed -- a difficult administrative task. For back income tax purposes the IRS has asserted against each college a 20 percent withholding tax on the excess of the aggregate asserted rental values over the aggregate rents charged. But had the college charged in the aggregate the rents the IRS maintains would have represented fair value, the college would have had to fix the rent properly for each unit, or if it did not it would have had to withhold the correct amount from each employee-tenant based upon his undercharge on his housing unit. In any event, for FICA purposes the IRS has had to assign a rental value to each unit because the wages of some employee tenants will have exceeded and some will not have exceeded the maximum amount subject to FICA tax in each particular year; and it asserts that the college is now liable both for the employer's and the employee's FICA tax.

Thus, under present law the proper rent for each unit of faculty housing is an issue for pre-1984 years and for post-1985 years.

In Central Illinois Public Service Co. v. U.S., supra, the Supreme Court said, as quoted earlier, that "Because the employer is in a secondary position as to liability for any tax of the employee, it is a matter of obvious concern that, absent further specific congressional action, the employer's obligation to withhold be precise and not speculative." We submit that employers are entitled to advance guidance of some kind from the IRS National Office in the withholding of income tax (by far the largest portion of the tax asserted against the four institutions) as well as FICA tax, if the IRS seeks to ignore the rental valuations set by the states. Indeed, again as quoted earlier, the Ways and Means Committee report accompanying the 1984 Act calls on the Treasury to establish for the future "appropriate and helpful rules for the valuation of taxable fringe benefits" -- rules that are lacking for pre-1984 years.

Moreover, although the Service has had the occasion to examine similar faculty housing programs at other educational institutions, so far as we have been able to determine it is not asserting against them claims for tax liability similar to that pending against the four colleges. This circumstance underscores the inconsistency and lack of predictability in the Service's position on this issue.

V. There are no appropriate or helpful guidelines for valuation of faculty housing to be derived from existing court decisions.

The Senate Finance Committee report accompanying the 1984 Act (p. 777) observed:

> "Several court decisions have held that on-campus housing furnished to faculty or other employees by an educational institution under the circumstances involved in those cases did not satisfy the section 119 requirements, and hence that the fair rental value of the housing (less any amounts paid for the housing by the employee) was includible in the employee's gross income and constituted wages for income tax withholding and employment tax purposes."

A similar sentence was contained in the Joint Committee on Taxation staff pamphlet dated November 2, 1983, prepared for the Select Revenue Measures Subcommittee hearings on H.R. 677 and in the Joint Committee pamphlet dated July 25, 1984. The pamphlet cited Bob Jones University v. U.S., 670 F.2d 167 (Ct.Cl. 1982); Goldsboro Christian School, Inc. v. U.S., 79-1 CCH USTC ¶ 9266 (E.D.N.C. 1978); Winchell v. U.S., 564 F. Supp. 131 (D. Neb. 1983); and Coulbourn H. Tyler, 44 CCH Tax Ct. Mem. 1221 (1982).

The first three of these cases involved faculty housing for which no rent whatsoever was charged, and thus did not involve the issue whether participation in a faculty housing program in which the rent charged is sufficient to cover the college's cost of furnishing the housing nevertheless gives rise to income in the form of additional wages. In the fourth case a rent was charged and the employee sought to deduct the rent under section 119, a claim the court found clearly incorrect. In none of these cases, where no rent was charged, was there any apparent disagreement between the taxpayers and the Service as to the value to be placed on the free housing, and hence there is no discussion of the appropriate measure of value in any of these opinions. Only in Bob Jones University and Goldsboro did the IRS seek to hold the institution liable, and in those two cases there was no dispute about the rental values subjected to tax.

Not one of these four cases therefore provides any guidelines for determining whether rent actually charged by an educational institution, even though reflecting its costs, is so insufficient as to constitute additional compensation or wages to its employee-tenants.

VI. The "cost" standard for housing contained in section 531(g) of the 1984 Act is fair and reasonable, furnishes a feasible administrative standard, is supported by precedent, and is particularly appropriate for non-profit educational institutions.

Non-profit educational institutions covered by section 501(c)(3) obviously are not operated to make a profit. Yet that is precisely what the Service would require of the four colleges with respect to their faculty housing for pre-1984 years. The general principle used by these non-profit institutions in operating auxiliary facilities, such as cafeterias and housing for students, faculty, administrative officers and other employees, is that they should be self-sustaining, resulting in no significant overall profit or loss to the institution. This has been a policy recommended over many years by the business officers of the nation's colleges and universities. To the best of our knowledge, only for the four institutions involved in the present cases is the IRS asserting a tax liability in such circumstances.

The educational institution must take into account, in fixing rentals for faculty housing, its own housing operating costs and the rentals which its faculty tenants might reasonably be expected to pay in their financial circumstances. An additional factor might be the so-called "opportunity cost" to the institution-employer. See C. Eugene Steurle, "A Primer on the Efficient Valuation of Fringe Benefits," OTA Paper 51 (U.S. Treas. Dept. 1982). The "opportunity" that the college has as an alternative is not to rent the housing to the highest bidder, for that would undermine the college environment sought to be maintained. The alternative would be renting to students; this is sometimes done, but the rent charged to students in such cases is the rough equivalent of the rent charged to faculty.

For example, Rev. Rul. 68-322, supra, involving meals and lodging furnished to student-employees by a sorority, states that "the cost of the meals and lodging to the sorority is not in and of itself determinative." Yet the proper measure of value to the student-employees would doubtless be the amount charged to student members who are not employees. If, as is likely, those charges are based on cost, no inquiry should be made as to what a public for-profit restaurant would charge its customers.

A similar issue would be raised if the Congress should adopt the President's proposal to limit the exclusion in Int. Rev. Code § 117 for scholarships to "tuition and equipment required for courses of instruction, but not for room and board." President's Proposals, p. 58. The amount includible in income of a scholarship student covering "room and board" would doubtless be the amount paid to the college for room and board by non-scholarship students, although the non-profit college undoubtedly furnishes room and board to non-scholarship students at its cost, without making a profit on them. The same result should flow for faculty housing.

It would be patently unfair to require every college at its peril to determine a "fair market value" for each of its faculty housing units each year, subject to second thoughts by IRS personnel or judges who might have different views of the aggregate rental levels or to the relative rentals of different units. Some "appropriate and helpful" national guideline from the IRS is required, as the recent committee report accompanying the fringe benefit provisions of the 1984 Act concludes, for the guidance of the institutions for post-1985 years. For pre-1984 years the state valuation rules, to which the IRS has referred -- but which it has ignored in the cases of the four colleges -- furnish guidance, and the rents actually charged are well above those amounts.

From an administrative standpoint the operating cost standard used in the 1984 Act moratorium (section 531(g)) furnishes a readily determinable safe harbor test and eliminates dispute as to the separate rentals to be charged for each housing unit, since it applies on an aggregate basis for all the housing units. This is the standard that has been applied by IRS with respect to meals (see Technical Advice Memorandum #7740010, dated June 30, 1977); and section 132(e)(2), as added by the 1984 Act, similarly brings certain "eating facilities" under the de minimis fringe exclusion if "revenue derived from such facility normally equals or exceeds the direct operating costs of such facility."

The 1984-1985 moratorium, the recent conference report states, is not intended to furnish any inference as to the rule applicable to earlier years. But the enactment of a moratorium on adoption of any regulation relating to faculty housing acknowledges the existence of a vacuum in the federal regulations relating to earlier years. Unless this vacuum is filled for those earlier years by the adoption of an "appropriate and helpful" rule such as is contained in the 1984-1985 moratorium, the issue would be left to litigation, and the judiciary would have to supply guidelines for the past -- guidelines that would have retroactive effect on the secondary withholding tax liabilities of the four colleges.[2]

VII. Treasury's proposed valuation of travel on company-owned aircraft provides a useful precedent.

The Treasury Department has, pursuant to congressional direction, proposed to revise regulations so that "appropriate and helpful rules" would exist for the valuation of personal flights by employees, families and guests on company aircraft. Assistant Secretary Ronald Pearlman wrote House Committee Chairman Rostenkowski on May 1, 1985 to propose a "safe harbor method of valuing" such personal flights. The safe harbor is to be calculated by using 50 percent to 100 percent of the "safe harbor value for airline parents," which is itself only 50 percent of the coach fare on commercial airlines. The result is to use as a safe harbor value 25 percent to 50 percent of the coach fare on commercial airlines.

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[2] If litigation involving the four colleges should result in judicially developed standards for prior years different from those contained in section 531(g), an anomalous situation would exist for the years 1984 and 1985 since section 531(g) merely prohibits the issuance of regulations (and presumably administrative rulings) but does not by its terms deal with the application of judicial doctrines.

As stated by Mr. Pearlman, this percentage factor applied to a standard rate is intended to provide "a workable regulatory framework." As shown above, the ad hoc approach used by IRS engineers to value faculty housing is unworkable and inconsistent. Clearly a "safe harbor method" is needed here also. We believe that the cost standard provides a workable, consistent safe harbor. An alternative to the use of the cost standard would be the use of national median rents that are compiled and published by the Federal government in its Annual Housing Survey. The use of these national median rents for valuing faculty housing would be an acceptable standard, comparable to the safe harbor values established on a national basis for company airplanes.

VIII. Conclusion: Section 531(g) of the 1984 Act should not be confined to the years 1984 and 1985, but should be made applicable to preceding and subsequent years.

We respectfully submit that Congress should not leave the four institutions with this overhanging potential liability in indeterminate amounts awaiting years of costly litigation. Congress should also act to prevent the IRS's fair-market-value standard from threatening the viability of faculty housing programs in the future at these schools and others. Whether the educational institution is in an urban or rural setting, its objective in providing faculty housing -- of insuring a resident faculty -- will be severely undermined if it must operate faculty housing at a profit based on theoretical rentals that might be charged to the public.

We think that the most fair and equitable resolution of this problem is to apply the standards used in the moratorium in section 531(g) to the years prior to 1984 and after 1985 as well. We urge Congress to enact such a standard in the context of its action on tax reform in the 99th Congress.

STATEMENT OF
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FOR THE RECORD OF THE
JULY 19, 1985, HEARING ON EMPLOYEE BENEFITS
BEFORE
THE COMMITTEE ON FINANCE
UNITED STATES SENATE

JULY 30, 1985

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This statement is submitted by Gerald L. Uslander, a principal of William M. Mercer-Meidinger, Incorporated, the world's largest consulting firm in the field of employee benefits, compensation, and communications. Mercer-Meidinger's more than 10,000 clients come from every category of business, industry, government, and non-profit organization and range in size from small employers to the largest corporations in the world. These clients sponsor a diversity of employee benefit programs.

SUMMARY

Our major concern is that the proposals to amend Section 401(k), relating to cash or deferred arrangements, would effectively eliminate such arrangements as viable retirement plan options for most employers. Plans with Section 401(k) features have successfully encouraged many employees, including large numbers of lower paid employees, to increase their retirement savings. Prohibiting hardship withdrawals would strongly discourage participation by younger and lower paid participants.

The proposed new actual deferral percentage test and the proposed $8,000 cap on contributions, particularly when coupled with offsets of IRA contributions, would impose unwarranted administrative burdens on employers and discourage the formation of Section 401(k) arrangements.

Accordingly, the Section 401(k) proposals should be rejected.

Similarly, the proposed uniform nondiscrimination rules should be rejected. The proposed test fails to recognize the needs of two-wage-earner families and ignores the problems of geographical differences and of employers in multiple lines of business. The current discrimination rules for pension plans are adequate, and, if rules are needed for welfare benefit plans, extension of the familiar pension rules would be sufficient and would avoid the administrative burdens associated with the adoption of the Administration's proposals.

We also urge rejection of the proposed tax on health benefits and the proposed elimination of favorable tax treatment for lump sum distributions and unrealized appreciation in employer securities. At a minimum, any new provisions regarding lump sum distributions, unrealized appreciation, and the proposed increases in the penalties for premature distributions should apply only with respect to amounts accrued after enactment. Deferred effective dates and adequate grandfathering are needed to allow sufficient time to redesign plans and inform participants of the changes. Most employers have not yet assimilated or communicated all of the changes from the recent and seemingly unrelenting significant legislation affecting benefits, and further piecemeal benefit legislation without realistic, deferred, effective dates must be avoided.

Each of these points is addressed more fully below.

CASH OR DEFERRED ARRANGEMENTS

It is gratifying that the President did not include the Treasury's proposed repeal of Section 401(k). However, it is likely that the proposed changes to Section 401(k) would accomplish the same result.

The stated purpose for the various proposals regarding qualified retirement plans is to enhance their utility as retirement savings vehicles. The proposed Section 401(k) amendments would have exactly the opposite effect. The Treasury continues to view Section 401(k) arrangements as shelters for the highly compensated and argues that further restrictions are required to assure that funds being deferred by employees at all income levels will be available for retirement. These concerns are groundless.

Section 401(k) Significantly Benefits the Lower Paid

A survey by Swinehart Consulting Inc., an Atlanta based market research firm, conducted for the Employers Council on Flexible Compensation, found that one out of every four U.S. employees (20 million) are covered by a Section 401(k) arrangement. A 1983 survey co-sponsored by the Employee Benefit Research Institute (EBRI) and the U.S. Department of Health and Human Services and conducted by the U.S. Census Bureau found that 54.6% of the 2.7 million surveyed employees covered by Section 401(k) arrangements earned less than $25,000.

A survey conducted by the Association of Private Pension and Welfare Plans earlier this year confirms these findings. Two hundred twenty-eight companies, employing 4.8 million employees, responded to the survey. Of these companies, 188 sponsored Section 401(k) arrangements. An average of 69% of the employees of each company are eligible to participate. While 76% of the upper one-third (by compensation) of eligible employees participate, as many as 59% of the lower two-thirds (by compensation) of eligible employees also participate.

These surveys show that a very large number of employers offer Section 401(k) plans to their employees and that participation by the lower paid in them is broad.

Hardship Withdrawal Provisions Should Be Continued

The proposed prohibition on in-service withdrawals would inhibit the effectiveness of Section 401(k). Other qualified savings plans would continue to permit in-service withdrawals (subject to a proposed penalty tax).

Our experience is that the current hardship withdrawal provisions are not overutilized. Consequently, there is not the high degree of pre-retirement withdrawals of Section 401(k) deferrals, as some have charged. Elimination of the ability to obtain funds for hardships would fall hardest on the lower paid who generally have more limited resources and options to meet unexpected financial demands.

Prohibiting In-Service Withdrawals Would Cause Lower Paid and Younger Employees To Cease Participation

We believe that many lower paid and younger employees would cease to participate in plans if in-service withdrawals were prohibited. Few, especially those with limited resources, will save if the savings are unavailable for emergencies.

Mercer-Meidinger is currently conducting a survey of employees covered by Section 401(k) arrangements to determine employee reaction to the proposals. The results will be provided when the survey is completed.

We predict that it will show that the younger and lower paid employees would be discouraged from participating in Section 401(k) arrangements and that they would consume the funds they otherwise would have deferred for retirement, rather-than depositing these funds in an IRA. History shows us that lower paid and younger employees have not participated significantly in IRAs, and there is no reason why this would change.

Recent EBRI survey statistics on IRA participation are relevant. In 1981, 12.1 million tax returns reported IRA deductions; in 1982, 16.7 million. The following table shows the use of IRAs by compensation ranges.

Taxable Income	Distribution of Total Returns By Income Bracket 1981	1982	Percentage in Each Bracket Using IRAs 1981	1982
0 - $19,999	22.8%	18.9%	4.3%	11.0%
$20,000 - $49,999	58.3	59.6	21.8	29.0
$50,000 and ovcr	18.9	21.5	52.0	57.6

1982 was the first year that workers covered by employer-sponsored retirement plans could contribute to an IRA. This data shows that the percentage of the total number of returns in each income range remained about the same, and, while the percentage of taxpayers in each range using IRAs increased slightly, it is still heavily slanted toward the higher paid. According to a recent Investment Company Institute survey reported by the Wall Street Journal, IRA participation remains slanted toward the higher paid and participation at the lower levels continues to be minimal.

The EBRI survey shows similar results for IRA participation by age. The older an employee, the more likely the employee is to participate in an IRA. The following table shows this result for 1982.

Age	Distribution of Total Returns By Age	Percentage In each Bracket Using IRAs
Under 25	2.7%	2.3%
25 - 34	18.6	10.8
35 - 44	23.7	18.5
45 - 54	27.2	29.3
55 64	24.9	37.2
65 and over	2.9	17.1

New ADP Test Could Cause Employers To Abandon Section 401(k)

The proposed actual deferral percentage test (ADP test) would allow a much narrower differential between the prohibited group and other employees.

Further, the ADP test would be an individual by individual test instead of an average deferral percentage test. The combined effect would be to significantly reduce the elective deferral of each member of the prohibited group, and this is without regard to the proposed $8,000 cap on elective deferrals.

This would greatly diminish the relative value of a 401(k) arrangement for many employees. The proposals would also greatly complicate administering a Section 401(k) arrangement. In combination, many employers would decide that it is not worth the added expense to maintain a plan.

Furthermore, an ADP test, particularly one more stringent than current law provides, is not needed. A cap on elective deferrals would control the amount that any prohibited group member might contribute. As long as the cap is set at a reasonable level, there would be no real threat of discrimination.

If a cap is adopted, then the concept of an ADP test for discrimination should be abandoned. If an ADP test is retained, it must be the current ADP test. To do otherwise would cause the result described above: employers would tend not to sponsor Section 401(k) arrangements.

The $8,000 Deferral Cap Is Too Low

There is no apparent reason for the proposed $8,000 limit on elective contributions. It seems far too low and arbitrary. It could have a dramatic effect on employees who are not members of the new prohibited group.

For example, if an employee earned more than $46,000 and made a $2,000 IRA contribution, the cap on elective deferrals would prevent the proposed 15% limit on deductible contributions from being reached. In the case of such an employee, the limit on elective Section 401(k) contributions would be $6,000, and this limit would be reached before the 15% deductible limitation. Many employees earning between $46,000 and $50,000 (the earnings level at which an employee automatically becomes a member of the prohibited group) would not be in the prohibited group, but they would be prevented from making the maximum deductible contribution. It is doubtful that this was an intended result. Furthermore, since the $50,000 would be indexed, while the $8,000 cap would not, more employees would be affected by the cap with the passage of time.

The cap should be abandoned, and Section 401(k) participants should be permitted to defer up to the contribution limitation that is allowed for other qualified defined contribution plans.

The IRA Contribution Offset Would Be an Administrative Nightmare

The proposal would create an administrative nightmare by requiring that the $8,000 cap be offset by any IRA contribution made by the employee. Elective Section 401(k) contributions are ordinarily made throughout the year. However, IRA contributions can be made until April 15 of the following year.

A 1984 survey conducted by the Life Insurance Marketing and Research Association shows that nearly two-thirds of all initial IRA contributions are made between January 1 and April 15 of the following year. It would be impossible for an employer to know with certainty and on a current basis if an employee would be making an IRA contribution, attributable to the current year. If the employee does make such an IRA contribution, the Section 401(k) arrangement could be disqualified because of it.

If there must be a Section 401(k) cap, and if it and IRA contributions must be related, then the penalty for overcontributing should be to treat the IRA contribution as an excess contribution. Disqualifying a Section 401(k) arrangement would penalize innocent employees, rather than only the offending employee.

Tax-Exempt and Public Employers Should Have Access to Section 401(k)

The proposals would prohibit all tax-exempt and public employers from sponsoring Section 401(k) arrangements on the grounds that they have access to their own "tax-favored elective contribution plans for retirement savings" and that access to Section 401(k) would be duplicative.

This is misleading. Only certain tax-exempt and very few public employers may use a ,tax-sheltered annuity under Section 403(b). The remaining public employers only have access to eligible state deferred compensation plans which are unfunded and do not provide the same security as Section 401(k) arrangements.

The many tax-exempt employers who cannot use Section 403(b) tax-sheltered annuities would not have access to funded elective deferral plans if Section

401(k) arrangements were unavailable to them. The proposals would extend to them the eligible deferred compensation programs available to states, but this would not solve the problem. Section 401(k) should remain accessible at least to public employers, and to any tax-exempt employer to whom a Section 403(b) tax-sheltered annuity is not available.

Many tax-exempt and public employers have established Section 401(k) arrangements and have received favorable determination letters from the IRS. These employers incurred considerable time and expense to establish these plans. It would be grossly inequitable if they now had to abandon them. If some or all tax-exempt and public employers are to be prohibited from maintaining Section 401(k) arrangements, then any such existing Section 401(k) arrangements should be grandfathered to the extent of current deferrals.

UNIFORM NONDISCRIMINATION RULES

The proposed uniform rules will not correct any existing problem. They would create problems. They have minimal, if any, revenue impact. They do not foster the Administration's goals of fairness, equity, or simplicity and should be rejected.

Current Discrimination Rules Work

The proposed nondiscriminatory coverage test for a retirement plan would require that the percentage of prohibited group members eligible to benefit under the plan may not exceed 125% of the percentage of non-prohibited group employees eligible to benefit. The results needed to satisfy this test are substantially different from the results that would satisfy the current 70/80 or reasonable classification tests.

This current test, especially when coupled with the general nondiscrimination rules, effectively prevents qualified retirement plans from being discriminatory. The public is comfortable with the test and knows how it works and how the IRS can be expected to interpret it. There is no reason to interject new and complicated rules.

Uniform Coverage Test Must Recognize Two-Wage-Earner Families

The uniform coverage test for welfare benefits would require that the percentage of prohibited group members actually benefiting under a plan not exceed 125% of the percentage of non-prohibited group employees actually benefiting. The test would apply to covered employees rather than employees eligible to benefit. It fails to take into consideration two-wage-earner families, where both spouses do not need coverage. Unless the IRS specifically rules otherwise, in order to pass the 125% test, the employer might have to cover the second wage earner. IRS discretion in granting exceptions would not give employers the assurance they need in expending time and money in providing coverage. If the test is deemed necessary, it should be on the basis of eligibility for benefits. Dual coverage of individuals is of benefit to no one and contrary to efforts to contain health care costs.

Uniform Coverage and Benefits Tests Ignore Geographical Differences and Multiple Lines of Business

Both the proposed uniform coverage test and the proposed uniform benefits test fail to consider geographical differences and employers who are in more than one line of business. Failure to recognize geographical differences in pricing, experience, and state coverage requirements would be unreasonable. The rule must permit different benefit levels for different plants, units, and locations for multi-state employers or controlled groups of employers where such differences are justified by geographic differentials.

Under the proposal, in performing the discrimination test, all related employers would be treated as one. This would require an employer in more than one line of business to aggregate all plans for coverage purposes. In most situations this would create problems. Only comparable plans can be aggregated. The required aggregation would not permit different types and levels of benefits customary in different lines of business. If uniform rules are deemed necessary, they should be designed so that aggregation is only necessary within a single line of business. Any such rules could contain guidelines to control abuses and prevent an employer from restructuring merely to pass a discrimination test.

Welfare Benefit Discrimination Is Not a Broad Problem

There are certain instances, confined to specific types of coverages, where discriminatory welfare benefit plans exist. However, there is no broad discrimination in welfare benefits. Consequently, uniform nondiscrimination rules that will cause many problems, some of which have been discussed, and will require enormous recordkeeping and data gathering are not justified.

If specific benefits where problems are inherent can be identified, rules designed to correct those problems should be formulated. Complicated rules that create problems where there were none before results in overkill. Furthermore, any rules adopted must allow for changing state law requirements which, by definition, are not uniform.

As an alternative, a set of rules that are workable and are already familiar to employers should be adopted. For instance, the same 70/80 or reasonable classification test now used in conjunction with qualified plans under Section 401(a) could be extended to welfare plans. Under that test, only "comparable" benefits and plans can be aggregated.

The mechanical 70/80 part of the test could easily be used in appropriate situations. It requires that either 70% of all employees participate or 80% of all eligible employees participate if 70% are eligible. However, in those cases where there are special circumstances, such as geographical differences or multiple lines of business, an employer could use the reasonable classification test. This test would be satisfied by demonstrating that there is a fair cross section of employees covered by comparable benefits at each location or combination of locations or within one line of business. In applying the test to any covered group, the fact that other groups exist or have benefits which are not "comparable" would be irrelevant, so long as each covered group does not discriminate in favor of the prohibited group.

Integration of LTD and Pension Should Not Be Coordinated

Many employers sponsor both pension plans and long term disability plans that are integrated with Social Security. The proposal would require adjustments to assure that credit for Social Security is not taken twice. The general perception is that offsetting both a pension benefit and a long-term disability benefit would be taking double credit. This perception is flawed. In most circumstances pension benefits and long term disability benefits are paid at different times.

HEALTH TAX WOULD BE HEAVY BURDEN FOR LOWER PAID

The proposed tax on health benefit premiums would impose a heavy tax burden on lower paid employees. It would add the same amount of taxable income to the lower paid as it does to the higher paid. This would be a far greater proportionate increase in taxable income for the lower paid than for the higher paid. Thus, it would be regressive.

And the burden goes beyond the federal income tax. Many states follow federal concepts of taxation and would include this additional amount in their income tax base. The additional income apparently would also be subject to FICA and FUTA.

Shifting to a tax cap would not solve the problem. It would lead to adverse selection. Employees would tend to elect lower cost coverage in order to minimize or eliminate the tax burden. As a result, employees would not have the coverage they need and the burden of providing it would fall on the government.

Taxing the cost of health care is nothing but a revenue measure. It should be abandoned in the interest of fairness and assuring our workers have adequate health care protection.

LUMP SUM AND UNREALIZED APPRECIATION RULES SHOULD REMAIN UNCHANGED

The proposals to repeal the rules governing lump sum distributions and deferred recognition of unrealized appreciation upon distribution of employer securities are unwarranted. They would frustrate long-standing retirement planning and would cause unnecessary, harsh results, particularly for the lower paid.

Capital gain and/or averaging treatment for lump sum distributions has been provided for over forty years. The present rules mitigate the effect of receiving a large distribution of taxable income in a single year which is attributable to amounts earned over a working career. There would appear to be no reason, other than revenue, to repeal present law. Certainly, the repeal of capital gain and ten year averaging for lump sum distributions would do nothing to foster retirement saving.

Similarly, immediate taxation of unrealized appreciation upon distribution of employer securities would create an unecessarily harsh result. It would cause many to sell securities to raise the cash necessary to pay the tax. Employees "own" the securities accumulated in their individual accounts. The mere change in form of ownership, from trust to direct ownership, should not be an event of taxation. Taxation should occur only on sale and recognition of the gain accumulated during the holding period.

At a minimum, the repeal of the capital gain and ten year averaging rules for lump sum distributions and of the deferral of unrealized appreciation on employer securities should be prospective only. That is, the new rules should apply only to amounts accumulated after the date of enactment. Distributions of amounts accumulated prior to the enactment of the proposal should remain eligible for lump sum distribution treatment and deferral of unrealized appreciation. These funds were accumulated, and retirement planning made, on the assumption that this tax treatment would be available. There is precedent for this type of grandfathering both in the Tax Reform Act of 1969 and in the Employee Retirement Income Security Act of 1974.

GRANDFATHERING AND DEFERRED EFFECTIVE DATES NEEDED

Both welfare and retirement plan amendments must contain adequate grandfathering of existing arrangements and deferral of effective dates. As indicated above, two such situations are the repeal of capital gains treatment and ten year income averaging for lump sum distributions and the repeal of the deferral of unrealized appreciation in employer securities.

A further example is the proposed new penalty tax on premature and excess distributions. It should only apply to prospective accumulations. Funds were accumulated and benefits earned on the expectation of penalty free access. This should not be disturbed.

Deferred effective dates are essential so that employers will have ample opportunity to determine how they must make changes in their programs in order to comply and will have sufficient time to actually make the changes in legal documents and in administrative procedures.

EMPLOYERS CANNOT TOLERATE FURTHER PIECEMEAL LEGISLATION

Employers can no longer tolerate piecemeal legislation affecting their maintenance of critical employee benefits. Many are still trying to assimilate, implement, and communicate to employees the changes recently made to comply with TEFRA, DEFRA, and REA. Repeated changes are expensive, cause employee confusion and disillusionment, and discourage plan formation and retention.

CONCLUSION

We would welcome the opportunity to work with you in examining the proposals and their effect in actual cases.

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